The New York
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Wentworth F. Gantt
Managing Editor

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, $2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.*

STATE SOCIETY ACTIVITIES

Calendar of Events

June 3 — Eighth Annual Outing, Westchester Country Club, Rye, N. Y.

June 12—Regular Meeting of the Board of Directors.

June 27-29—Eighth Regional Chapter Conference, Higby's, Big Moose, N. Y.

Chapter Elections

At recent annual meetings the four chapters of the Society at Albany, Buffalo, Rochester, and Syracuse elected the following officers for the coming year:

Albany Chapter

Irving L. Simon............*President*
John B. Cantwell......*Vice President*
David L. Kessler..........*Treasurer*
Eugene J. Steiner..........*Secretary*

Buffalo Chapter

Benjamin L. Enloe.........*President*
Harry E. Care........*Vice President*
Ralph H. Franclemont.....*Treasurer*
Maynard W. Lockwood....*Secretary*

Rochester Chapter

Herman A. Miller.........*President*
Oscar L. Niles........*Vice President*
Andrew H. Sophie.........*Treasurer*
Edmund A. Randall.......*Secretary*

Syracuse Chapter

Charles F. Carr...........*President*
Raymond F. Murphy..*Vice President*
Arthur L. Nicholson..*Sec'y and Treas.*

Communication

50 Broadway
New York
June 2, 1941

To The Editor
THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

Many of your readers, during long experiences in practice, accumulate files of accounting magazines and of miscellaneous fugitive accounting literature. To them these items seem worth saving, at least for a time. But unless these individuals put all this material into the libraries of their firms, or make specific provision as to its disposition after they are through with it, the material is almost certainly lost. Here are a few recent examples of such losses:

J. S. M. Goodloe's papers were burned on a public dump;
William F. Weiss' papers were discarded as trash;
George Wilkinson's papers were partly salvaged after several years;
John Moull's papers have never been located;
Homer A. Dunn's papers went, no one knows where.

Would it not be well to suggest to accountants that such material which they have preserved will still have a value after they are gone if they arrange for its deposit with the State Society, the American Institute or some public library where it will be preserved?

Yours very truly,
NORMAN E. WEBSTER.

1941 Year Book

Special attention of the membership is called to the change in the date of the issuance of the 1941 Year Book. This publication, which has formerly appeared in July, will not be published this year until October 1941. This is due to the change in the By-Laws of the Society which states that after March 31, 1941 the fiscal year shall end on September 30th of the succeeding

calendar year. Included in the 1941 Year Book will be a resumé of the activities of the Society for the full eighteen month period of April 1, 1940 to Septemer 30, 1941.

Eighth Chapter Conference

At Higby's Club, Big Moose, New York, the Society's Eighth Chapter Conference will commence on Friday, June 27th and last through Sunday, June 29th. The committee which has prepared the program hopes that as many members as possible will attend this year and bring their families with them. It also wishes to call attention to the excellent golf, tennis, and boating facilities available; of special interest to tennis players are the four clay courts. The Conference Committee announces the following program:

Friday, June 27, 1941

Morning—Informal Sports

Luncheon—1 P.M.

Afternoon Session— 2:30 P.M.

"What a Banker Expects from a C P.A."
Thomas W. Rourke, President of National City Bank of Troy, N. Y.

"Auditing Procedure on Government Contracts."
Edwin E. Leffler, C.P.A., Chief of Liaison and Settlement, U. S. Quartermaster General's Department.

Evening Dinner—6:30 P.M.

Evening Session—8:30 P.M.

"Extent of Interim Work Acceptable for Year-end Examinations."

(A) From the Viewpoint of the Larger Client.
Benjamin L. Enloe, C.P.A.

(B) From the Viewpoint of the Smaller Client.
Maynard W. Lockwood, C.P.A.

Ladies' Entertainment

Afternoon—Boat Ride around Big Moose Lake.
Tea at Higby's.

Evening — Bridge.

Saturday, June 28, 1941

Morning Session—10 A.M.

"The Value of a Competent Insurance Counselor."
John J. Holohan, Jr., Insurance Counselor.

Luncheon—1 P.M.
Steak Roast at Lakeshore.

Afternoon—Golf and Tennis Competitions.

TROPHIES

Competition for F. H. Hurdman Trophy for Chapter Golf Teams—
Victor H. Stempf Low Gross Golf Trophy.
James F. Hughes Low Net Golf Trophy.
Morris C. Troper Tennis Trophy.
Additional prizes have been arranged for by the Committee.

Evening Dinner—7 P.M.
Address (Subject to be announced).
A. S. Fedde, President of the Society.

Ladies' Entertainment—Afternoon.
To be arranged.

Sunday, June 29, 1941

Informal sports and general relaxation.

Eighth Annual Outing

On June 3, 1941 the Society's Annual Outing and Tournament was held at the Westchester Country Club, Rye, N. Y. The Society was fortunate in having beautiful weather, which resulted in a most successful day's outing. An unusual group of prizes had been selected for winners in the golf and tennis tournaments, which were keenly contested. The following members were given awards:

Golf

The President's trophy for the best (low gross) score was won by R. A. Henry with a 79, while Francis Wm. Hopkins was the winner of the Lafrentz trophy for low net with a score of 73. Winners in each of the three low net groups, all of whom received prizes, were as follows, together with the scores as turned in:

CLASS A

R. A. Henry....................72
Rudolph Mattis 74
Thomas W. Brown.............77
W. J. Bird.....................78
James W. Howorth, Jr...........82

CLASS B

Robert R. Booth................74
M. H. Conway..................75

Thomas F. Conroy..............76
James H. Malloy...............78
Benjamin Glaser 78
A. P. L. Prest.................78

CLASS C

Francis Wm. Hopkins...........73
Louis S. Stamm................77
Lawrence Meyers 78
Wm. D. Keveney...............79
A. J. Bauer....................85
William H. Peterson, Jr..........86

Tennis

This year the tennis tournament had more entries than for several years past, and included a number of "dark horses"—one of whom succeeded in emerging the victor. Alexander Jablow, a new member of the Society this year, played four matches, or a total of nine sets, to gain the new Leidesdorf Tennis Trophy. Last year Armand L. Bruneau retired the former trophy by winning it for three years in succession. Through the kindness of Mr. Leidesdorf, another beautiful silver trophy was donated to replace the one retired by Mr. Bruneau. In winning this year's tournament, Mr. Jablow overcame the formidable opposition of two of the Society's best tennis players, namely, Sidney B. Kahn, who lost to him in the semi-final round, and Frederick M. Bruell, whom Jablow defeated in a hard-fought final match. Everyone was sorry that Mr. Bruneau could not participate again this year due to illness, although he kindly offered to umpire the final match, and lent his assistance to the smooth running of the tournament.

Just to be sure that everyone got plenty of exercise, it was decided this year to hold a consolation tourney composed of those players who were eliminated in the first round. The winner of this event was John G. Rankin, who played a long final match with Charles R. Rauth. In addition to the Leidesdorf trophy, prizes were also awarded to Alexander Jablow, Frederick M. Bruell (runner-up) and John G. Rankin.

Results

Leidesdorf Trophy

First Round: Renato Crisi won from Thomas H. Hanley by default; Alexander Jablow defeated John Riker 6-1, 6-4.

Second Round: Sidney B. Kahn defeated Charles R. Rauth 6-3, 6-2; Alexander Jablow defeated Renato Crisi 6-2, 6-2; Frederick Bruell defeated Robert E. Moss 6-1, 6-2; George Jablow defeated John G. Rankin 6-3, 8-6.

Semi Final Round: Alexander Jablow defeated Sidney B. Kahn 2-6, 6-4, 6-3; Frederick M. Bruell defeated George Jablow 6-0, 0-6, 6-4.

Final Round: Alexander Jablow defeated Frederick M. Bruell 6-3, 6-4. (Umpire—Armand L. Bruneau).

Consolation Tournament

First Round: John G. Rankin defeated Robert E. Moss 4-6, 6-3, 7-5; Charles R. Rauth defeated John Riker 2-6, 6-1, 6-3.

Final Round: John G. Rankin defeated Charles R. Rauth 6-4, 7-5. (Umpire—Joseph W. Welsh).

Door prizes were won by George Jablow, (brother of A. Jablow), Armand L. Bruneau, and Victor H. Stempf.

Members in Government Service

The following is a list of members and associate members who have entered the armed forces of the nation to date:

Raymond E. Barker
Harold S. Benjamin

Kermit J. Berylson
Robert S. Brumagim
Charles Daum
Frederick W. Earnhardt
Samuel Eisen
Samuel E. Ellis
E. George Fuchsman
Lewis Gluick
Moore P. Huffman
Stuart Jenkins
Harold Keller
Andrew C. King
Edward M. Lausted
R. Louis Lazo
James F. Leach
Clifton F. Leatherbee
Adlai Richard Lewis
David J. Lewis
Robert C. Loudon
Samuel G. Marcus
Wallace A. Mitchell
Allen Eugene Murison
Harold J. Olson
Leon L. Radin
Jesse Rubenstein
Joseph Schultz
Albert Sobel
Ernest I. Steinberg
Henry van Daalen, Jr.
Joseph J. Wagner
Charles F. Werber, Jr.

Eleanor L. Gantt

It was with the deepest regret that members of the Society and staff learned of the sudden death on June 13th of Eleanor L. Gantt, wife of Wentworth F. Gantt, Assistant to the President. Those of us who have been associated with Mr. Gantt in the work of the Society extend to him and to the family of Mrs. Gantt our greatest sympathy at this time on behalf of the entire membership.

F. Harvey Bush

F. Harvey Bush, a member of the Society since July, 1932, died suddenly on May 9th, at the age of 52.

He is survived by his widow and a half-sister.

James A. McKenna

James A. McKenna, a valued and esteemed member of the Society since March, 1898, died on May 21, 1941, at the age of 85.

In his death, this Society as well as the accountancy profession at large, has sustained the loss of an able and loyal member whose long record of devotion to the practice of his profession has contributed much to the development of accountancy and has exerted an influence which will long survive him.

Mr. McKenna is survived by his widow, a daughter, and two sons.

PROFESSIONAL COMMENT

Wages and Hours and the Accounting Profession

On April 15, 1941, the Wage and Hour Division of the U. S. Department of Labor issued the following release clarifying its regulations with respect to employees of accountants who may be engaged in interstate commerce:

Accountants and the Wage and Hour Law

The Fair Labor Standards Act of 1938 applies to employees engaged in interstate commerce or the production of goods for interstate commerce. Whether an employee is so engaged depends, of course, upon the facts in the particular case. The Interpretative Bulletins Nos. 1 and 5 discuss the general coverage of the Act. Bulletin 5 states:

> Attention is called to section 3 (i) which defines goods to include articles or subjects of commerce of any character. It seems clear that the term "goods" includes publications, pamphlets or any other written materials. Accordingly employees engaged in the collection and dissemination of information which is transmitted to other states in the form of publications, pamphlets or any other written materials are engaged in the production of goods for commerce even though the actual work of printing may be done by an independent printing establishment. Typically this would apply to employees of organizations such as trade associations and research compilation services. It should be noted, too, that such employees may well be engaged in commerce inasmuch as the continued use of the mails and the channels and instrumentalities of interstate commerce in collecting and disseminating information may bring the employees' work within the category of work in interstate commerce.

Employees of accountants who are engaged in preparing stockholders' reports, balance sheets, or other financial statements and documents which are sent out of the state directly by their employer or indirectly by his clients would seem to fall within the general coverage of the act. The same is true with regard to those employees engaged in activities incidental to the preparation of such materials. Interpretative Bulletin No. 1 says:

> The second category of workers included, those engaged in the production of goods for (interstate) commerce, applies typically but not exclusively, to that large group of employees engaged in manufacturing, processing, or distributing plants, a part of whose goods moves in commerce out of the State in which the plant is located. This is not limited merely to employees who are engaged in actual physical work on the product itself, because by express definition in section 3 (j) an employee is deemed to have been engaged in the production of goods, if such employee was employed in producing, manufacturing, mining, handling, transporting, or in any other manner working on such goods, or in any process or occupation necessary to the production thereof, in any State. Therefore the benefits of the statute are extended to such employees as maintenance workers, watchmen, clerks, stenographers, messengers, all of whom must be considered as engaged in processes or occupations necessary to the production of the goods. Enterprises cannot operate without such employees. If they were not doing work necessary to the production of the goods they would not be on the payroll. Significantly it is provided in section 15 (b) that proof that any employee was employed in any place of employment where goods shipped or sold in commerce were produced, within 90 days prior to the removal of the goods from such place of employment, shall be prima facie evidence that such employee was engaged in the production of such goods. Hence, except for the special categories of employees within the exemptions of section 13, all the employees, in a place of employment where goods shipped or sold in interstate commerce were produced, are included in the coverage, unless the employer maintains the burden of establishing, as to particular employees, that their functions are so definitely segregated that they do not contribute to the production of the goods for interstate commerce as these terms are broadly defined in the act.

Section 13 (a) (1) of the act says:

> Sec. 13. (a) The provisions of section 6 and 7 shall not apply with respect to (1) any employee employed in a bona fide executive, administrative, professional, or local retailing capacity, or in the capacity of outside salesman (as such terms are defined and delimited by regulations of the Administrator);

Employee employed in a bona fide "professional" capacity is defined in the Regulations Part 541, as follows:

> Any employee who is
>
> (A) engaged in work—
>
> (1) predominantly intellectual and varied in character as opposed to routine mental, manual, mechanical, or physical work, and
>
> (2) requiring the consistent exercise of discretion and judgment in its performance, and
>
> (3) of such a character that the output produced or the result accomplished cannot be standardized in relation to a given period of time, and
>
> (4) whose hours of work of the same nature as that performed by non-exempt employees do not exceed 20 per cent of the hours worked in the work week by the non-exempt employees; provided that where such non-professional work is an essential part of and necessarily incident to work of a professional nature, such essential and incidental work shall not be counted as non-exempt work; and
>
> (5) (a) requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education and from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes; or
>
> (b) predominantly original and creative in character in a recognized field of artistic endeavor as opposed to work which can be produced by a person endowed with general manual or intellectual ability and training, and the result of which depends primarily on the invention, imagination, or talent of the employee, and
>
> (B) compensated for his services on a salary or fee basis at a rate of not less than $200 per month (exclusive of board, lodging, or other facilities); provided that this subsection (B) shall not apply in the case of an employee who is the holder of a valid license or certificate permitting the practice of law or medicine or any of their branches and who is actually engaged in the practice thereof.

Any employee who satisfies these conditions is exempt from both the wage and hour provisions.

There are, of course, many stages of professional expertness among accountants. It is clear that the ordinary bookkeeper who performs simple calculations is not a professional worker. We have also expressed the opinion that certified public accountants rendering professional services may generally qualify under the exemption afforded, provided they are compensated on a salary or fee basis at a rate of at least $200 per month.

All employers whose employees are entitled to the benefits of the act are required to keep records; however, no particular form is prescribed. In this connection Section 516.2 states:

> No particular order or form is prescribed for these records, provided that the information required in section 516.1 is easily obtainable for inspection purposes.

Of interest to accountants will be the 1941 edition of the WAGE AND HOUR MANUAL, recently issued by the Bureau of National Affairs, Washington, D. C. This volume of 1120 pages is priced at $5.00 and embraces, so far as can be discovered, all documentary material available on government regulations of wages and hours. Supplementing the basic material are answers to questions on the law's application to specific cases, and a compilation of all court decisions under the Wage and Hour Law to March 1941.

The volume is in three parts, the first dealing with overtime, minimum wage and other provisions of the Fair Labor Standards Act, and the second covering the Walsh-Healy Act, as well as miscellaneous

laws regulating wages and hours. The third part takes up state legislation, including child labor and industrial homework regulations for each state. There is also an excellent topical index and table of cases.

Non-Profit Institutions Accounting

During the past year the Society's Committee on Non-Profit Institutions Accounting has prepared a general bibliography of available material pertaining to hospitals, schools and universities. It has also reviewed and appraised certain of the more important material in this field, although that which has been reviewed to date does not attempt to exhaust the sources available. The complete bibliography and individual reviews by members of the Committee are now obtainable upon request at the Society's office. As a preface to their work, the Committee presents the following memorandum, to which is appended a list of the material already reviewed:

Organizations in the Non-Profit Institutions Field have increasingly come to the realization that greater results can be accomplished with the development of the program and work when there is an adequate financial policy supporting the planning of the organization and a sound fiscal structure on which to operate.

A commercial organization is established for the sole purpose of earning a profit on the funds invested. A non-profit organization is not a corporation organized for financial profit. Consequently a commercial or industrial system of accounting does not in general meet the distinctive financial problems encountered in the management of an organization dependent upon different sources of income for the support and extension of its work.

Non-profit institutions of the present day, in many cases with endowment funds, more or less extensive building and equipment investment, and with increasingly complicated business problems, cannot be operated effectively or efficiently unless they are prepared to follow the soundest business and accounting principles.

It is therefore necessary to have a comprehensive understanding respecting supervision of the investment of funds, accounting for the receipt and disbursement of funds, preparing and supervising an adequate budget which will properly regulate expenditure to income limits, preparing statements which will at all times reflect the true financial condition of the organization and the results of its operations for a given period, and sundry like responsibilities which should round out for the organization a sound and complete financial policy.

In some instances the larger organizations of this type have faced the situation and have provided an efficient financial record and control, understanding that it is the soundest and after all, most economical thing to do. However, it is in all probability more important that the smaller institution, with greater limitations in respect to its total resources, should be administered under the most efficient business principles.

These institutions in a very real sense are semi-public organizations. The making of a profit is not their aim. Success is measured not in terms of net income but in service to the community. There is moreover a trustee relationship to the constituency and contributing public to the same extent as any trustee is completely responsible and accountable for work or funds placed within his jurisdiction.

A budget plan adapted so as to provide authorizations for disbursements and to control operating receipts in connection with institutional activities, should be one of the fundamental items in the financial planning. The work should be limited to the extent of the income available for the organization. If the institution administers its finances on the basis of its needs and demands only, without relation to its available income, serious financial difficulties are certain to arise. It is generally accepted, in respect to this type of financing, that no organization is under obligation to perform a service for which it cannot meet the cost. Where a demand for service develops, the customary appeal for funds may be made, but if these funds are not supplied, the organization has no responsibility to incur debt to meet the situation.

The science of accounting and financial and business management should be made readily available to all non-profit institutions in the best interest of the work for which they are organized.

Every institution of necessity assumes a heavy responsibility in the trustee relationship created in accepting from the community and constituency the funds

with which to carry on its particular work for that community.

There was a time not very long ago when one of the criticisms levelled at philanthropic, social-work and other like non-profit organizations as a group was that funds given for the support of the work were never adequately accounted for. It might be assumed that this charge in all probability may not have implied dishonesty, but it very decidedly indicated poor and unwise management.

To a degree this situation has improved, but the work of non-profit organizations financed by a contributing public nevertheless carries a weighty responsibility in this respect, and individual institutions should endeavor to stimulate confidence in the constituency in every way possible. After all, in simply meeting the requirements of any trustee, in addition to indicating honest and intelligent management, the increased confidence develops greater interest on the part of the constituency and hence greater support and a larger future for the work of the institution. Especially in times of difficult financing there exists perhaps an even greater obligation on the part of organizations carrying a trustee relationship to the public, to account in an adequate way for the handling of funds so generously given.

It is an acknowledged fact that an institution in this capacity owes to its constituency, the contributing public, to its membership, its board and its employed officers, a duty to have verified the fact that every dollar received and disbursed by the institution has been properly accounted for. This objective is secured by means of a certificate of professional accountants who after an adequate examination can certify that all funds which should have been received were received and that all expenditures made were properly authorized, and furthermore that all assets and liabilities have been accurately recorded and presented. Disbursements should be verified to see that proper bills, receipts or other evidence of indebtedness support the record of payment and that expenditures were duly authorized. Income from contribution and other sources should be verified to determine that all earnings and pledges have been properly received and reported or otherwise accounted for.

Once this responsibility is established, and for the most part it is generally accepted today, the matter of scope in relation to the audit requires consideration. Many professional accountants render various types of services, from a complete detailed audit to a brief examination. There are instances in institutional work where a brief verification is of necessity so extremely qualified that it is of questionable value. The auditor's certificate so qualified may, in fact, be misleading, and the financial statement in all likelihood will not be explicit or interpretative.

If all of these factors could enter into the consideration of the Board of Directors responsible for the financial stability of the organization work, undoubtedly more adequate provision would be made for so important a responsibility.

A service of this nature would, in addition to meeting the institution's general responsibility in this respect:—

(a) Protect the income sources by verification of income and collections.

(b) Safeguard the institution expenditure by verifying supporting vouchers and authorizations.

(c) Determine and report accurately the actual financial resources and obligations of the institution as at the close of the fiscal period, as supplementary to the Income and Expenditure report for the period.

From the form and types of reports rendered by some of the non-profit organizations, it is possible that many Boards of Directors may not be aware of the actual financial status of their respective organizations.

Material on Which Reviews Are Available

HOSPITALS

Accounting and Business Procedures for Hospitals

by Herbert R. Sands. Prepared by the New York Conference on hospital accounting under the auspices of the United Hospital Fund of New York (United Hospital Fund of New York, c 1933, 195 pages).

Procedure for Hospital Costs

by William A. Dawson. United Hospital Fund of New York, 370 Lexington Avenue, New York, N. Y. 1937. 2 parts with 11 illustrative schedules of working sheets. 30 pages.

System for an Endowed Hospital

by William Rodney Thompson (in his Accounting Systems, their design and installation, 1936).

Hospital Accounting and Statistics

by American Hospital Association. A manual for American Hospitals. Third edition, 1937. 87 pages.

System of Financial Control for Hospitals
by G. Waite Curtis. Banco Corporation, Printers and Publishers, San Francisco, 1932, 46 pages.

General
Duties and responsibilities of the Comptroller by William A. Dawson (4 mimeographed pages).
Allowances by William A. Dawson (6 mimeographed pages).
Linen Control by William A. Dawson (3 mimeographed pages).
Systematizing the office by William A. Dawson (6 mimeographed pages).
Using the United Hospital Fund Report to tell the story of the Hospital by William A. Dawson (5 mimeographed pages).

COLLEGES AND UNIVERSITIES

University and College Accounting
by Lloyd Morey, New York, John Wiley and Sons, Inc. c 1930, 323 pages.

Financial Reports for Colleges and Universities
by National Committee on Standard Reports for Institutions of Higher Education. University of Chicago Press, Chicago, Illinois c 1935—285 pages.

Principles and Practices of Financial Accounting for Schools
by John Guy Fowlkes. E. M. Hate and Company, Milwaukee, Wisconsin, 1934, 238 pages.

Accounting Manual for Colleges
by Gail A. Mills. American Council on Education, Financial Advisory Service, Washington, D. C. 1937, 165 pages.

COMMITTEE ON NON-PROFIT INSTITUTIONS ACCOUNTING,
FREDERICK J. HALLER,
Chairman.

Revision of Internal Revenue Code

The Society's Committee on Federal Taxation has drawn up a memorandum setting forth certain specific recommendations for modification of the Internal Revenue Code. With the approval of the Board of Directors, this memorandum was sent to the individuals listed in the accompanying letter, which is published below together with the text of the Committee's recommendations.

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June 13, 1941.

Sir:

The COMMITTEE ON FEDERAL TAXATION OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS is pleased to submit for your consideration a memorandum on revision of the Internal Revenue Code with especial reference to individual and corporate income taxes, the corporation capital stock tax and the declared value excess profits tax. The Committee has concerned itself mainly with problems of sound income determination, correction of hardships and the equitable administration of the Internal Revenue Code. Consequently, it has avoided questions as to rates, personal exemptions, credit for dependents and taxation of State and Municipal interest. The Committee will be glad to amplify any of its recommendations and will be happy to cooperate in any way to give effect to these recommendations.

Copies of this memorandum have been sent to:

Mr. Colin F. Stam, *Chief of Staff, Joint Committee on Internal Revenue Taxation*

Mr. Guy T. Helvering, *Commissioner of Internal Revenue*

Mr. John L. Sullivan, *Assistant Secretary of Treasury.*

Members of Ways and Means Committee of the House:

Robert L. Doughton, *Chairman*	Knute Hill
	Arthur D. Healey
Thomas H. Cullen	Aaron Lane Ford
Jere Cooper	Allen T. Treadway
John W. Boehne, Jr.	Frank Crowther
Wesley E. Disney	Harold Knutson
Frank H. Buck	Daniel A. Reed
Richard M. Duncan	Roy O. Woodruff
John D. Dingell	Thomas A. Jenkins
A. Willis Robertson	Donald H. McLean
Patrick J. Boland	Bertrand W. Gearhart
Milton H. West	Frank Carlson
Raymond S. McKeough	Benjamin Jarrett

Members of Finance Committee of the Senate:

Pat Harrison, *Chairman*	R. M. LaFollette, Jr.
Walter F. George	Tom Connally
David I. Walsh	Josiah W. Bailey
Alben W. Barkley	Bennett Champ Clark
Peter G. Gerry	Harry Flood Byrd
Joseph F. Guffey	Arthur Capper
Prentiss M. Brown	Arthur H. Vandenberg
Clyde L. Herring	James J. Davis
Edwin C. Johnson	Henry Cabot Lodge, Jr.
George L. Radcliffe	John A. Danaher
	Robert A. Taft

Yours Very Truly,

COMMITTEE ON FEDERAL TAXATION OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS,

By NICHOLAS SALVATORE,
Chairman.

- - - - -

RECOMMENDATIONS FOR MODIFICATION OF THE INTERNAL REVENUE CODE

WITH SPECIAL REFERENCE TO INCOME TAXES AND TO CORPORATE CAPITAL STOCK AND DECLARED VALUE EXCESS PROFITS TAXES

The Committee on Federal Taxation of the New York State Society of Certified Public Accountants makes the following recommendations for the revision of the Internal Revenue Code, with especial reference to income taxes (individual and corporate), and to corporate capital stock and declared value excess profits taxes.

The Committee has avoided such controversial questions as rates, personal exemptions and taxation of state and municipal interest. Its recommendations are concerned mainly with problems of sound income determination, correction of hardships and the equitable administration of the code.

The recommendations are stated as succinctly as possible and comment added to indicate the reasons prompting them. No specific statutory language is now suggested nor attempt made to work out complete solutions. It need hardly be said the Committee is prepared to elaborate any of the points thought worthy of consideration and to assist in preparing the necessary statutory amendments.

1. Consolidated returns:

Authorize consolidated *income tax* returns for affiliated corporations; and wherever consolidated excess profits tax returns are filed by an affiliated group, require consolidated income tax returns—the test of affiliation to be made uniform under both sections.

(*That a parent company and its affiliates form a natural accounting unit for tax purposes need not be stressed here—nor the advantages in the matter of the preparation and audit of returns. The recent partial restoration of the consolidated return privilege—for excess profits tax only—makes its application to corporate income taxes the inescapable next step.*)

2. Intercorporate dividends:

Amend section 26(b) so as to grant domestic corporations generally, credit of 100% (instead of present 85%) of dividends received from other domestic corporations, without limiting the credit to the recipient company's net income.

(*The injustice of forbidding consolidated returns is aggravated by the present tax on dividends from one affiliate to another. If the consolidated return privilege is not restored, some relief from the present tax on inter-affiliate distribution is at least due companies that are members of an integrated affiliated system.*)

3. Capital gains from partial corporate liquidations:

Amend section 115(c) to remove the arbitrary classification of all gains from distributions in "partial liquidation" as "short term" capital gains, without regard to holding period.

(*If not made universal, this section should at least be amended so as not to apply to the redemption of preferred stock without a claim on earned surplus beyond a small premium on redemption.*)

4. Cancellation of indebtedness:

Establish a uniform rule for *all* insolvent or bankrupt debtors and debtors in "unsound financial condition", so that no settlement with creditors (regardless of the form adopted or procedure followed) will give rise to taxable income.

Provide also that the reduction of the tax basis of property retained by the debtor under any such settlement be no greater than the amount that would (in the absence of the proposed uniform rule) be regarded as taxable income; but in no event should the required adjustment cause the basis of any property to be reduced below its fair market value.

(*This proposal is limited to insolvent or financially embarrassed taxpayers; and its object is to extend to all taxpayers the benefits now granted only to taxpayers that proceed under the* ***Bankruptcy Act.***)

5. Bad debts:

Modify section 23(k) so that ascertainment of the worthlessness of bad debts and their "write off" need not be contemporaneous and so that premature write off or proof of subsequent write off will be recognized as compliance with the write off requirement.

(*This will prevent legitimate bad debt losses being denied because found by the department to have been ascertainable in some prior year (not yet outlawed) and merely on the ground that there was no "write off" on the books in such earlier year; naturally not, for in the taxpayer's view, no loss was ascertainable that year.*)

6. Worthless stock:

Introduce a taxpayers' "area of discretion" with regard to losses on worthless corporate stock, giving them some latitude in "ascertaining" the year of loss, somewhat akin to the ascertainment of losses on "bad debts", limiting the area however to a period bounded by two years before and two years after the year of the "identifiable event" as determined by present tests.

(*The difficulty of identifying the actual events that give rise to stock losses has caused endless controversy which can be avoided, in large measure, by this suggestion.*

Publication by the Department of its determination of years of worthlessness will also help the administration of the worthless stock provision.)

7. Non-business expenses and taxable income:

Amend section 23(a)(1) to recognize all expenses incurred in the production of any income that is regarded as taxable under the law, including expenses necessary to the conservation of assets with income-producing potentialities.

(*The need for this amendment has been emphasized by the recent decision of the United States Supreme Court in the Higgins case. The New York State income tax law has contained such a provision for many years.*)

8. Items not deductible:

Amend section 24(b) so as to disallow capital losses on the sale or redemption of wholly tax-exempt bonds to the extent of any unrecovered premium paid on the acquisition of such bonds.

(*Correspondingly, discount should be recognized as exempt interest, but not beyond a maximum, say, of ten points—for the entire discount on "speculative" bonds cannot fairly be regarded as interest.*

As to premium, it is fair that it be allocated, in effect, against totally exempt interest, where bonds are purchased on a yield basis.)

9. Final return for decedent taxpayer:

Modify sections 42 and 43 so that when a decedent's final income tax return (when placed on the accrual basis) contains more than a year's normal income from a partnership or a trust or income from any source in an abnormal amount, the abnormal amount will be segregated and taxed separately—at the same average rate that the normal amount of income appearing in the decedent's final return will be taxed.

(*The United States Supreme Court has recently held in the Enright case that a partnership on a cash basis must accrue its income to the date of a partner's death and that the decedent's distributive share of such accruals must be reflected in his last return. This requirement may cause an extraordinary amount of income to be placed in brackets beyond that usual for this taxpayer on his normal income. The law plainly intends that no income received or accrued during a taxpayer's life should escape taxation—but it should not attempt to impose more tax than would be paid in the normal course on the income involved had his life continued. The law should be amended to remove this bulge in a decedent's last return.*)

10. Definition of reorganization:

Elaborate the definition of "reorganization" so that the term "recapitalization" (section 112(g) (1) (E)) will include "Refinancing"—thus making it possible for a company and its creditors to exchange "tax free" for equal or lesser amounts, new "long term" bonds or debentures (say, with a life of ten years or more) for outstanding bonds or debentures, the interest rate on the new debt to be no greater than the rate on the superseded debt.

(*This suggestion reflects the views of the Board of Tax Appeals in the recent case of Sigmund Neustadt Trust (43 B.T.A. No. 122). Its adoption as a clarifying amendment will remove the present uncertainty and permit internal corporate adjustments to proceed freely. To prevent abuse, it is directed only to exchanges for equal or lesser amounts of long term bonds, with interest rates no greater than that of the old debt.*)

11. Party to a reorganization:

Redefine term "party to a reorganization" (section 112(g)(2)) to include the company issuing its voting stock for substantially all the properties of another corporation, as well as the wholly owned

subsidiary to which the property thus acquired may have been transferred.

(Before the Groman decision, it was generally held that the acquisition of property for stock came within the "tax-free" provisions even when title passed to a wholly-owned subsidiary of the issuing corporation. Congress should undo the effect of this decision (as it did in the Hendler case) by making this change retroactive—to protect not only taxpayers but also the Treasury against taxpayers who may otherwise avail themselves of undeserved stepped-up bases.)

12. Suspension of statute of limitations (Section 3801):

Redefine the term "determination" to include (1) the Commissioner's expressed acceptance of a return, and (2) expressed acquiescence by taxpayer in agent's report and payment of demanded additional assessment.

(Section 3801 may be invoked only after there has been a final "determination" of the tax for a given year—the term "determination" being restricted however to closing agreements, refund claims and decisions of the Board of Tax Appeals and Federal Courts. Many taxpayers may be deprived of the intended benefits of this section unless it is liberalized by recognizing as "determinations" less formal occasions such as suggested in this recommendation.)

13. Section 112(b)(7) of 1938 Act and Corporate dissolutions:

Revive section 112(b)(7) of the 1938 Act to permit the dissolution of personal holding companies and other companies with large security holdings, so that tax on appreciated assets distributed in liquidation may be postponed until sold by the stockholders.

(There should however, be no time limit for acting under its provisions; or if a limit is provided, the period fixed should be generous. Also, corporate stockholders should be allowed to qualify and should not be barred by the 50% control test that the 1938 Act imposed.)

14. Income for short period placed on annual basis:

Modify the formula prescribed by section 47 for placing income for a short period on an annual basis, by providing that the computed annual income for this purpose shall be the sum of the actual income of the short period and the actual income (but no net loss) of a sufficient number of succeeding months to equal a twelve month period.

(An inequity (or perhaps an undue benefit) may develop under the present rule when the income of a short period, to be placed on an annual basis, is not average or truly representative of a taxpayer's normal net income.

Where the "succeeding months" show a net loss, it is suggested that the actual short period income be taxed as though it were a full year's income.)

15. Appeals to the Board of Tax Appeals on refund claims:

Extend to the Board of Tax Appeals jurisdiction over income tax refunds denied by the Commissioner, providing a routine similar to that outlined in section 732, without any limitation on the issues that may later be appealed to the Circuit Courts.

(The more informal procedure of the Board makes that body more accessible to taxpayers than the District Court or the Court of Claims.)

16. Notch provisions—Corporation income tax:

Provide that the first $25,000. of net income of *all* corporations be taxed uniformly at graduated rates or at one flat rate.

(This is suggested to avoid the need for the troublesome alternative computation of the tax for corporations with income slightly in excess of $25,000. — Section 13(b)(2).)

17. Land as capital asset:

Amend section 117(a)(1) to remove land (*used in business*) from the "capital asset" category.

(Upon the sale of land with a building thereon, the loss or gain on each must be computed separately and placed in different categories. With the $2,000. limitation on corporate "long-term" losses removed, a loss on land, held 18 months or more, is now fully deductible, so there is no tax difference despite the nominal difference in classification. But where land and buildings are "short term", the land loss may not be deductible even though the building loss will be deductible at once. A building loss may enter an "operating loss carry-over" but a land loss (being capital) may not. This confusion can be removed simply by placing both business land and building in the same non-capital group.)

18. Losses from intrafamily sales, etc.:

Where under section 24(b), a loss on a sale has been disallowed, permit the purchaser to continue the seller's base and holding period, limiting the purchaser's base to his own cost should a loss on subsequent sale be claimed.

(Without questioning the wisdom of preventing the "registering" of losses by shifts between members of a family group and

its corporate and trust creations—it is needlessly harsh to deny the effects of a sale to the seller and yet treat the purchaser as having made a genuine purchase from an outsider. Some concession should be made to the possibility of legitimacy by allowing the vendor's base to continue. To check misuse of the continued base, require the use of the vendee's "cost" in the event of a loss claim—a limitation now imposed on the sale of property received as a gift.)

19. Stock dividend redemption as taxable dividend:

Correct the effect of secton 115(g) (where under its terms stock issued before 1936 as a non-taxed dividend is redeemed and the redemption is held to be equivalent to a taxable dividend) by permitting the stock, on which such stock dividend had been issued, to be restored to its original unallocated base.

(*Justice obviously calls for this adjustment. The present law does not demand it nor does Section* 3801 *seem to apply. And where such stock, in the hands of a purchaser for value, is redeemed, the purchaser's base should be applied to reduce the dividend or be recognized as a total loss; treating it as a capital loss would not be fully compensatory.*)

20. Credit for British income taxes:

Provide specifically that British income taxes withheld at the source by the companies paying the dividends, be recognized as an income tax credit to American stockholders under Section 131.

(*The foreign income tax credit was introduced originally with the approval of the State and Treasury Departments, so that Americans would not be hampered in their investments or business abroad; and for years, American taxpayers were given credit for the British tax on dividends. This credit is not now available because the United States Supreme Court in the Biddle case held that the liability for the tax rested initially on the paying corporation. The Court however acknowledged that the tax was generally passed on to stockholders and that under English practice was recognized as their tax. However sound the Court's conclusion may be legalistically, the original reasons for giving Americans credit for such taxes still persist.*)

21. Personal holding companies and capital loss limitation:

Remove the $2,000. net capital loss limitation in section 505(d) so that a "deficit" company with current income, offset in whole or in part by non-deductible net capital losses, will be taxed under this section only on net undistributed current income *after* such losses and so that the distributions up to the amount of such available net current income will clearly constitute dividends to stockholders and dividend-paid credits to the company. If possible, this suggestion should be made to apply retroactively to 1937.

(*Or alternatively, provide for "consent dividends", after the manner of Section* 28, *so that stockholders of such companies may report as dividends an imputed but undistributed net current income, which will automatically entitle such companies to dividend-paid credits.*

The $2,000. *limitation on deductible capital losses now applies only to personal holding companies. Even where such disallowed losses exceed other current income and create a current deficit, that "other income" is nevertheless regarded as present and distributable and may be subjected to the punitive surtax of* 75%. *A company with an ample opening surplus may avoid the tax by making a surplus distribution. But for a company with an opening deficit, there is no way out—it simply must pay this prohibitive tax out of capital. There being no "earnings or profits", prior or current, any attempt to procure a dividend-paid credit will be unavailing, for distributions by a deficit company will not be taxed to stockholders and will by definition be ineligible as a dividend-paid credit.*)

22. Corporations not essentially "personal holding companies", so taxed:

Amplify Section 502 so that companies without the usual personal holding company characteristics are not treated as such.

(*This has reference to a typical holding company (not an incorporated pocketbook) with completely owned operating subsidiaries, whose entire income must necessarily be dividends from such subsidiaries. It refers also to unmistakable operating companies in low income years, when non-operating income from interest, dividends, etc. may bring them now and then within the formula of Section* 501, *so as to constitute them personal holding companies, thereby also exempting them from the excess profits tax—both results presumably not contemplated by Congress.*

The objection with respect to a holding company and operating subsidiaries will be removed in great measure merely by restoring the consolidated return privilege.)

23. Undistributed profits tax:

(a) Amend Section 14(a)(1) of the 1936 and 1938 Acts to permit the deduction of an opening operating deficit in the computation of adjusted net income.

(*This retroactive amendment is suggested to give relief to corporations so bound by charters or statute that they*

could not legally make the distributions that the 1936 and 1938 Acts contemplated.)

(b) Amend Section 27(a) of the 1936 and 1938 Acts so that, where after Treasury examination or Board or Court decision, additional taxable income is found and such additional income (or any part thereof) is distributed to stockholders as a taxable dividend, the company will be given a dividend paid credit as an offset to this additional income.

(For this purpose, a procedure similar to that prescribed by Section 506, with respect to personal holding companies, should be found suitable.)

24. Waiver of Statute of limitations and refund claims:

Amend Section 276(b) so that an agreement between the taxpayer and the Commissioner of Internal Revenue extending the period for making additional assessment will automatically extend the period for filing claims for the refund of overpayments.

(To stave off assessment before agreement has been reached, taxpayers generally find it advisable to agree to a suspension of the statute of limitations. There is no quarrel with this practice except that it is one-sided, for it fails to suspend the statute with respect to possible overpayments. Taxpayers may unthinkingly assume that the consent leaves open their right to refund; but unless a refund claim has been independently and timely filed, the statute runs against them and bars a refund despite an ultimate finding by the Commissioner himself of an overassessment.)

25. Information returns by accountants:

Repeal Section 3604 of the Code requiring accountants to file information returns with respect to formation or reorganization of foreign corporations.

(This information should be procured on returns filed by companies involved, their officers, directors and stockholders. The release given lawyers by the 1939 Act should be granted accountants.)

26. Referees—Board of Tax Appeals:

Authorize the Board of Tax Appeals to appoint paid referees or commissioners to take testimony and prepare findings of fact—final hearing and argument however, to be before a Board member or members.

(This follows the practice of the United States Court of Claims and should speed up the disposition of cases.)

27. Non-resident alien individuals and foreign corporations:

If Sections 211(a) and 231(a) are amended to increase the rates on non-resident alien individuals and foreign corporations, such change should be made effective as of some date subsequent to the signing of the new revenue act.

(This will make withholding requirements conform to the tax rates effective on all dates of withholding and will relieve the department of the impossible task of collecting from foreigners, past taxes that American withholding agents were under no duty to withhold.)

28. Capital stock and "declared value" excess profits tax:

(a) Repeal capital stock (Section 1200) and "declared value" excess profits tax (Section 600):

(The original purpose of these related taxes will now be fully served by the more significant excess profits tax.)

(b) If not repealed—permit these taxes to be applied as an offset to the "excess profits tax".

(The present and proposed schemes of excess profits taxation will reach genuine excess profits as determined by tests sounder than those prescribed by these sections. By applying them as an offset, it will avoid duplication and will assure a minimum contribution to the revenues by all corporations without regard to their income.

(c) If not repealed—reenact Section 1202(a).

(This is suggested to give corporations a chance to redeclare a higher value in the light of changed conditions.)

(d) If not repealed — amend Section 1202(b) so that the corporate income and excess profits taxes paid or accrued will reduce "declared value"; also

(e) When a corporation has distributed all its assets in complete liquidation, any residual "declared value" will immediately and automatically be eliminated and no future tax demanded.

(The failure to originally provide in the law for these adjustments is probably due to oversight.)

Respectfully submitted,

COMMITTEE ON FEDERAL TAXATION
OF THE NEW YORK STATE SOCIETY
OF CERTIFIED PUBLIC ACCOUNTANTS

NICHOLAS SALVATORE, *Chairman*
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JACOB STEWART SEIDMAN
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WALTER E. WILLIAMS

Practical Tax Courses

Four practical courses dealing with all phases of federal income and estate taxes will be conducted by the Practising Law Institute as part of its summer session program of 17 courses for accountants and lawyers. These courses, which aggregate 68 hours of concentrated instruction, will be given by a group of tax experts, including three accountants, one law school professor, and nine practising lawyers. Messrs. Walter A. Cooper, J. S. Seidman, Christian Oehler, and Benjamin Grund, members of the Society, are listed as instructors of accounting and taxation. This year's session will be given during the two weeks commencing July 14, 1941, at the Hotel Astor, New York City.

A course on Fundamentals of Federal Taxation will present the basic principles of income and estate taxes. The practical handling of tax matters before the Treasury Department and before the Board of Tax Appeals will be dealt with in a course on Tax Practice and Procedure, while the provisions of the Excess Profits Tax Law will be studied in detail in a separate course. Specific problems such as loss and expense deductions, tax avoidance plans, corporate earnings and dividends, estate tax deductions, and the new Revenue Act are to be discussed in an advanced course on Current Problems in Taxation. The preparation of tax returns, and methods of minimizations will be considered in all the courses.

The Practising Law Institute is a non-profit, educational institution chartered by the Board of Regents of the University of the State of New York. A booklet describing these courses in detail is available upon request at the office of the Institute, 150 Broadway, New York City, or at the office of the Society.

RECENT PUBLICATIONS

TAX BARRIERS TO TRADE
By the Tax Institute
University of Pennsylvania
Philadelphia, 1941
344 pages, $2.50

This volume represents a symposium on this subject conducted by the Tax Institute in Chicago on December 2-3, 1940, to which 29 prominent authorities in the fields of business, law, economics and agriculture contributed. The Tax Institute, formerly the Tax Policy League, was recently integrated with the Wharton School of Finance and Commerce of the University of Pennsylvania under a grant from the Alfred P. Sloan Foundation.

INTERNAL AUDITING
By Victor Z. Brink, C.P.A., Ph.D.
Ronald Press, New York, 1941
549 pages, $4.50

This is the first complete volume published on the subject of internal auditing. The author, who is Instructor in Accounting at Columbia University, has made an extended study and investigation of this field. He brings together into one volume a survey of the methods and procedures being applied today by representative companies for the effective conduct of internal auditing activities.

GENERAL ACCOUNTING
By H. A. Finney, C.P.A., Ph.B.
Prentice-Hall, New York, 1941
604 pages, $5.35

Presenting the subject in clear and understandable language, this book describes the basic principles of business accounting while avoiding the detailed and technical ramifications of more comprehensive texts designed for practising accountants. It contains numerous examples of the various accounting procedures in general use today, and describes how the history of a business is recorded, its operations summarized, its financial condition stated and its budget forecasts expressed. Professor Finney is Professor of Accounting at Northwestern University, a former practicing certified public accountant, and the author of a number of recognized accounting texts.

BANK AUDITS AND EXAMINATIONS
By John I. Millett, C.P.A.
Ronald Press, New York, 1941
577 pages, $6.00

A revised edition to the original work published in 1927 was made mandatory, in the opinion of the author, by changing times and conditions which have in turn altered the details of bank examinations and audits and widened the scope of the examiner's work. The author is a practicing certified public accountant.

NEW YORK LAWS
Affecting Business Corporations
(Annotated)
United States Corporation Co., 1941
599 pages, $2.00

This is the twenty-second edition of this work, revised to May 3, 1941, and covering 67 separate amendments and additions contained in 36 separate acts emanating from the 1941 session of the New York State Legislature. Besides the statutes, it includes liberal annotations of judicial decisions in the form of abstracts, in the court's exact language, with numerous citations of supporting cases.

ACCOUNTS RECEIVABLE SYSTEMS FOR SMALL STORES
BOOKKEEPING AND CREDIT CONTROL
By Dr. Clyde William Phelps
Household Finance Corporation, Chicago, 1941

The first of these two monographs prepared by Dr. Phelps, who is Head of the Department of Economics of the University of Chattanooga, is the only existing treatise on accounts receivable systems for *small* stores, i.e., those stores which cannot afford to use the regular, high-priced bookkeeping machines found in large department stores and retail establishments. It describes the many different systems which can be posted by hand or by simple, low-cost machines, and is generously illustrated.

The second booklet is the only existing treatise which deals fully with the nature, functions and characteristics of a good accounts receivable system for *retail* stores. It is also profusely illustrated with pictures and cuts of the various forms, files and bookkeeping machines discussed in the text. Both monographs, of 60 and 48 pages respectively, are available upon request from the publishers.

ACCOUNTING
A Vocational and Professional Monograph
By Jeremiah Lockwood, C.P.A. and Calvin H. Rankin, LL.B.
Bellman Publishing Company, Boston, 1941
39 pages, $.50

This is the seventh in a series of occupational booklets being published by the Bellman Publishing Company on a variety of fields. In the case of accounting, a good deal of useful information is given which should be of value to anyone contemplating the profession as a career, either private, governmental or public. The field of public accountancy is well described, and the qualifications and requirements for the C.P.A. degree are fully discussed. The booklet answers questions as to personal qualifications, scholastic training, employment opportunities, remuneration, chances for advancement, and also includes a frank statement as to the advantages and disadvantages of accounting as a career. The authors are both well-recognized authorities in the field, Professor Lockwood being Professor of Accounting at the Wharton School of Finance & Commerce, while his collaborator is Assistant Professor of Accounting at the same institution.

ELECTIONS

The following is a list of applicants admitted to membership and associate membership in the Society, and also associate members advanced to membership at a meeting of the Board of Directors held on May 12, 1941:

Membership

Blomquist, Karl E., 132 Buffalo St., Jamestown.

Brady, Ambrose C., 165 Broadway, Of Hunter & Weldon.

Greenbaum, William S., Chatham-Phenix Bldg., L. I. C., With Stanley L. Greenbaum & Co.

Krepski, Adam, 89 Broad Street.

Ostrow, Charles, 1441 Broadway, Of Brown, Haber, Geller & Co.

Tumarkin, Harry, 152 W. 42nd Street, Of Tumarkin-Bernstein Company.

Vigdor, Philip M., 21 E. 40th Street.

Associate Membership

Blume, Philip H., 305 Broadway, With David Wax.

Cohen, Irving Jay, 85 Delancey Streeet, With The Public National Bank and Trust Company of New York.

Crean, Thomas Joseph, 140 Broadway, With Guaranty Trust Company of New York.

Dell, Julius, 1780 Broadway, With the Dale Radio Company, Inc.

Emanuel, Meyer M., Jr., 1108—16th St., N.W., Washington, D. C., With Oscar J. Bernstein.

Freelove, Arthur Franke, 191 Glen Street, Glens Falls, Of Ball, George & Co.

Halper, Alfred, 450 Seventh Avenue, With Louis Horowitz.

Jensen, Arthur Severn, 60 Broadway, Asst. Secretary & Asst. Treasurer, Blue Ridge Corporation.

Joel, Henry, 24 Commerce Street, Newark, N. J., With Sternrich & Siegel.

Kennedy, John T., 1012 Liberty Bank Bldg., Buffalo, With Lucker & Severance.

Kuraner, David M., 132nd Street & Lexington Avenue, With Maloney Materials Corporation.

Lyons, Erwin H., 154 W. 14th Street, With Strauss Fasteners, Inc.

Madden, Lawrence Joseph, 125 Park Ave., With S. D. Leidesdorf & Co.

Mandell, Harold, 1450 Broadway, With Shapiro & Shapiro.

McCabe, Peter A., 70 Pine Street, With Peat, Marwick, Mitchell & Co.

Moran, James P., 724 Garrison Avenue Bronx, With Cummins Diesel Engine Corporation of New York.

Natthen, Leonard Wallace, 74 Trinity Place, With Joseph Froggatt & Co., Inc.

Neubert, Cyril Vincent, Box 427, Olean, With Messer Oil Corporation.

Neuman, Lawrence, 175 Fifth Avenue, With Glickman & Glickman.

Oley, Francis Joyce, 108 N. Salina Street, Syracuse, With Federal Deposit Insurance Corporation.

Pusinelli, Eric, 19 W. 44th Street, Of Eric Pusinelli & Co.

Rabey, Harry Edwin, 90 Broad Street, With Lybrand, Ross Bros. & Montgomery.

Rega, Patrick R., 1401—37th St., Brooklyn, With Industrial Lithographic Company, Inc.

Schultz, Louis, 60 E. 42nd Street, With Klein, Hinds & Finke.

Shapiro, Sam, 6 E. 45th Street, With Irving Handel.

Sherwood, Eli Allan, 90 Broad Street, With Lybrand, Ross Bros. & Montgomery.

Sirkin, Sidney, 1450 Broadway, With David Berdon & Co.

Steinhauer, Frank, 205 W. 34th Street, With Irving Baron & Company.

Tombler, Harrison Francis, 110 E. 42nd Street, With C. V. McGinity.

Ward, Francis Bernard, 414 Starrett-Syracuse Bldg., Syracuse, With Scovell, Wellington & Company.

Zelon, Irving, 1457 Broadway, With Sol L. Leibner.

Advancement from Associate Membership to Membership

Farrell, Leonard J., 35 W. 45th Street,
Asst. Treas., Pathé Laboratories, Inc.

LaManna, Theodore J., 11 Park Place.

Leach, James Francis, Fort McClellan, Ala.,
With U. S. Company "D", 102nd Quartermaster Regiment.

Marcus, Abraham, 125 Park Avenue,
With S. D. Leidesdorf & Co.

Rogers, Llewellyn Le Roy, 80 Maiden Lane,
With Touche, Niven & Co.

Schaeffer, Emanuel, 450 Seventh Avenue.

Schlaffer, Alex, 120 Broadway,
With Barrow, Wade, Guthrie & Co.

Weiss, Andrew, 225 W. 34th Street,
With S. L. Klein & Company.

Yagoda, H. Howard, 233 Broadway,
With I. Arnold Ross.

The number of members in the Society as of June 1, 1941 is as follows:

Members	3,425
Associate Members	462
Total	3,887

The Role of the Accountant in Public Utility Regulation

By Edward F. Jannott, C. P. A.

The author is a member of The New York State Society of Certified Public Accountants, an associate of The American Institute of Accountants, and a member of the accounting staff of the New York State Public Service Commission.

His article outlines the work of the accounting staff of the Commission. It views that work from the Commission's standpoint. The author is expressing his own personal opinions and not the opinions of the Society or of any of its committees.

In "A Decade Of Utility Regulation" published in 1940 by the New York Public Service Commission there is the unqualified statement that "Proper accounting methods and practices are essential to effective utility regulation . . ."

More and more are regulatory bodies looking to the accountant for the promulgation and enforcement of regulatory measures. More and more are public utilities requiring the services of accountants, public and private, as a result of the current trend of utility regulation. For example, when the Federal Motor Carrier Act was passed in 1935 thousands of trucking concerns were obliged to engage public accountants to install new and redesign old accounting systems. This legislation also caused many of the smaller operators to remove their bookkeeping from the proverbial hat and put it in books.

Accounting as applied in public utility regulation is both constructive and analytical. It embraces not only the proper recording of transactions but also the interpretation of the recorded results.

It has long been recognized that complete supervision of a utility's affairs cannot be effectively exercised unless absolute control of the books of account is established. This control is usually accomplished by prescribing the method of keeping the accounts and commanding full access to the accounting records at all times. The method of keeping the accounts is set forth in detail by the regulatory body for each type of utility under its jurisdiction in what is commonly called the Uniform System Of Accounts. The Uniform System Of Accounts is the keystone of the constructive phase of accountancy in public utility regulation and constitutes one of the most important regulatory instruments.

Systems must be prescribed for a wide variety of enterprises such as telephone, electric, gas, steam, water, electric railroad, steam railroad, bus and trucking companies. The designing of a uniform system of accounts such as is used today by the most advanced regulatory bodies is a formidable undertaking calling for a specialized application of an exceptional accounting skill. The difficulty in designing a system becomes apparent when the factors involved are considered. A practical uniform system of accounts should

1. Provide a medium through which effective control of the accounts may be conveniently exercised.
2. Be based on generally accepted accounting standards.

3. Be adequate to serve as the general accounting structure for the enterprise.

4. Be adaptable to enterprises varying substantially in size.

5. Be coordinated with systems prescribed by other regulatory bodies to which the utility may be subject so that excessive duplication in the accounts may be avoided.

6. Adhere to the legally delegated powers of the regulatory body.

Although other experts such as lawyers and engineers participate to some extent in the designing of a uniform system of accounts the principal responsibility rests upon the accountant. Consequently the design of uniform accounting systems with few exceptions has advanced in step with the progress of the accounting profession. In cases where this is not so it has been despite the efforts of the accountant rather than otherwise.

Of course, the uniform system of accounts would have little value if it were not diligently adhered to by the utilities. Therefore it devolves upon the accountant to enforce the correct application of the appropriate system and to aid in the interpretation of its provisions where necessary. He must also be ready to advise and assist the companies on any special problems in connection with the recording of transactions.

The other principal medium through which control is exercised over the accounts and affairs of a utility is the Annual Report. Most regulatory bodies require each utility under their jurisdiction to file annually a report, very searching in character and designed to furnish information on all aspects of the enterprise. Here again a high degree of accounting skill must be employed in designing the form of such a report. It is actually a combination of permanent file, audit working papers and statistical study for a particular year. The main features of an annual report are a short history of the enterprise, a description of the equity ownership and affiliations with other companies, a list of the officers and principal stockholders (if a corporation), comparative balance sheets at beginning and end of the year with supporting detailed schedules, income statement with supporting schedules, description of the major units of property, various operating statistics and a digest of important contracts, agreements and commitments entered into during the year. In fact, a public utility annual report was always considered to be quite a formidable document—until the S. E. C. reports appeared.

When the annual reports are received by the regulatory body they are carefully reviewed by accountants experienced in this particular field. It is their duty first to see that the report is correctly and completely filled out, and second, carefully to analyze the material to see that it appears to be in order. Where necessary the report is augmented by correspondence. Major inconsistencies or discrepancies may require a field examination. These reports cannot nor are they intended to take the place of a field audit. In most cases, however, the office examination of the report will indicate any special circumstances that may warrant immediate attention.

Few if any utility regulatory bodies are equipped with the personnel necessary to make an annual field audit of each utility under its jurisdiction. Yet it would seem that such a course would contribute immeasurably to thorough, aggressive, impartial, day by day regulation. Regulation exists for the benefit of consumer and producer, both present and prospective. Incorrect account-

ing in a single year, unintentional or otherwise, might operate to the unfair advantage of one or more of these four groups at the expense of the others.

The constructive phase of the accountant's work in utility regulation is perhaps of the most far-reaching consequence; but the analytical or investigative phase, by sheer volume, is the most important to the accountant. The investigative work varies widely in character and may be classified according to purpose as follows:

General examinations	Capitalization
Valuation	Rate making
Mergers, consolidations and reorganizations	Special Studies

Aside from the obligation to observe the prescribed accounting procedures the mechanics and technic employed in any of these examinations differ little from those used in public auditing work.

The general examination may be made for purely routine reasons or in connection with security issues, mergers or consolidations. Insofar as the accounts are concerned this type of examination closely resembles a balance sheet audit. It involves the verification of the balance sheet accounts at a given date and such an examination of the income and expense accounts as will be sufficient to indicate that the prescribed accounting procedures have been followed. Changes in the fixed capital accounts, of special importance from a regulatory standpoint, are scrutinized in detail, usually in conjunction with engineers.

The three major phases of valuation work as currently applied to the physical property used in the operation of a public utility are the determination of (1) original cost (2) reproduction cost and (3) depreciation, annual and accrued. While the last two are primarily in the field of engineering the first is best accomplished by the engineer and the accountant working in close cooperation. The original cost of any property must of necessity be obtained from the books of account and collateral records, when these books and records are available.

Finding the original cost of the fixed assets of a utility often presents unusual problems and rarely fails to develop into a highly complex investigation. This is due in part to the necessity of examining old records prepared from 40 to 80 years ago when accounting methods were crude, and records tended to obscure rather than to enlighten. Furthermore the history of any sizeable utility company abounds in mergers, consolidations and reorganizations, each an obstacle in the path of those who seek to determine the actual cost of a venerable fixed asset as it exists today.

In connection with a merger, consolidation or reorganization the basic examination would be similar to the general examination already mentioned. To this would be added special features for the specific purpose. For example, an examination for a merger or consolidation would usually involve the preparation of consolidated financial statements, pro-forma balance sheets and projected operating statements. A reorganization might require in addition to the two last a statement of condition and a critical study of the reorganization plan. In these types of cases it is usually necessary to determine or verify the original cost of the fixed assets.

In cases involving changes in the capitalization, such as the issuance, increase or decrease in capital stock or bonded indebtedness the investigation would be similar to the general examination, with particular em-

phasis on the valuation of the property.

Rate making has for its object the determination of a price that the consumer will be required to pay for a unit of a particular commodity, such as gas, electric energy or water. The usual examination made for the purpose of rate making is very comprehensive, employing not only accountants but other technicians such as engineers, statisticians and rate analysts. In this type of examination the accountant's work has three major phases, all of primary importance. He is required to make an exhaustive study of the income and expense accounts for several years to determine the exact net profit or loss from the manufacture (or purchase) and sale of the commodity. He must determine the working capital necessary for the conduct of the operations. He must in most cases determine the original cost of the fixed assets devoted to the production, distribution and sale of the commodity or service.

The category of special studies includes a wide variety of work, usually of limited scope, not includible under the main classifications. For example, the accountant may be called upon to analyze some particular account on the books of a utility in connection with an engineering study. Or a utility may be contemplating the abandonment of a considerable portion of its facilities, due to obsolescence. The accountant must determine or verify the book value of the property involved and the effect of the proposed abandonment on the concern's financial position. Often the accountant is requested to assist in engineering and statistical studies either in an advisory or active capacity. Occasionally some spading is done in the fallow field of utility accounting research work.

The results of the various types of accounting studies and investigations are customarily presented in the form of a written report. The report is of no less importance in utility accounting than in public accounting. Reports may be formal, addressed to the regulating body, or they may be informal, addressed to a department head or other individual. They could also be classified functionally under two general types which might be termed underlying and transmitting.

The underlying report would be that prepared by the accountant in direct charge of the investigation and addressed to his immediate superior, department head or other person officially responsible for the matter at hand. The underlying report should state specifically the reason for the examination, its scope and purpose, a description of the work done, conditions found, recommendations made, etc. The importance of this detail cannot be overestimated. It is invariably necessary to refer to these reports years after their preparation and it is not uncommon to find a report 30 years old playing an important part in a current investigation. On any extended examination this type of report would be written as the work progressed.

The transmitting report would be that prepared by the person officially responsible for the transmitting of the result of the investigation in its final form. Its purpose is to transmit information from those who have obtained it to those who ultimately are to use it. The transmitting report is based on the underlying report but is less detailed and presents the subject matter in summary form for general use.

The results of utility accounting investigations are often presented in the form of testimony at public hearings before the regulatory body by the accountant acting in the capacity of an expert witness. The purpose of testifying in relation to utility ex-

aminations is to spread the factual data upon the official record of the case and to give the opposition an opportunity to cross examine the witness. Testifying demands a high standard of specific qualifications, thorough preparation and an intimate knowledge of the matter under consideration, together with the ability to grasp involved questions and give clear, concise, relevant answers. It is very exacting work and under certain conditions can be extremely nerve-racking.

Public utilities are engaged in producing and marketing commodities and services fundamental to our modern existence. Few wheels would turn without electricity. Commerce and industry would stand still without the telephone or railroad. Regulation of these great industries forms the basic control of the prices that the public, as consumers, pay for these commodities. No one contributes to this great task of regulation more of mind and hand than the accountant.

Law of Creditors' Rights

By I. Arnold Ross, C.P.A.

EVERY business day millions of commercial transactions take place in the City of New York based upon the extension of credit. The collection of the multitudinous debts created by these transactions is a colossal task and it is important that every business man should understand the rights and obligations of the parties involved. In this short article on the subject of the rights of creditors, the writer cannot, because of limitations of space, go into the minute ramifications of the principles of law which would be necessary were the article written for members of the Bar who make a specialty of the subject. It is the writer's hope that there is sufficient material here to give the ordinary business man some conception of his rights in enforcing the collection of his accounts.

In this discussion the writer will consider the entry and enforcement of a judgment; the creditor's rights in connection with fraudulent transfers; the creditor's rights in insolvency proceedings; and the creditor's participation in the rehabilitation of the debtor.

The Judgment as a Lien

Once a creditor's right to a judgment has been established and one has been granted by a court with the power and authority to do so, the judgment is recorded in the office of the clerk of the court. In order to become a lien upon real property, such judgment must be docketed in the office of the Clerk of the county where the judgment debtor owns real property, and it becomes a lien on the debtor's real property from the time of the docketing of the judgment in the county clerk's office. This lien is effective for ten years.[1]

A lien is created against personal property owned by the judgment debtor when an execution is issued by the judgment creditor's attorney to a marshal or sheriff directing such officer to levy upon the judgment debtor's personal property.[2]

Enforcement of a Judgment

A judgment may be enforced directly by the issuance of an execution to a marshal or sheriff directing such officer to levy upon the personal property belonging to the judgment debtor. If the judgment is not satisfied upon such a levy, the judgment creditor may obtain an execution upon the wages or other income of the judgment debtor to the extent of 10% thereof if the wages or income exceed $12.00 per week.[3]

The judgment creditor has the right to examine the judgment debtor concerning his assets in what are known as supplementary proceedings. The New York State Legislature in recent years has enlarged, to a great extent, the rights of the judgment creditor in such proceedings.[4] The law directs that for two years after the service of a subpoena or order in supplementary proceedings upon the debtor, he is enjoined from making any transfers of his property. This is a valuable remedy because the transfer by a debtor of property in violation of the statutory injunction constitutes a contempt of court which is punishable by fine and imprisonment and cannot be discharged in bankruptcy. The judgment creditor may also examine third parties who, there is reason to believe, have property in

[1] Civil Practice Act, Section 510.
[2] Civil Practice Act, Section 679.
[3] Civil Practice Act, Section 684.
[4] Civil Practice Act, Article 45.

excess of $10.00 belonging to the judgment debtor, or who are indebted to the judgment debtor.[5] The statutory injunction applies to such third party, as well, and enjoins him from transferring to the judgment debtor, or any other person, property belonging to the judgment debtor which might be applied to the satisfaction of the judgment.[6]

In connection with the examination of the debtor or a third party the judgment creditor also has the right to examine witnesses who may have any knowledge or information concerning the assets of the judgment debtor which might be applied to the payment of the judgment.[7] The right to conduct the above mentioned examinations is a very valuable aid in discovering property which might be applied to the payment of the judgment.

Where, in an examination in supplementary proceedings, it is discovered that a third party is indebted to the judgment debtor, the judgment creditor may obtain an order of the court directing such third party to pay over to the sheriff or to the judgment creditor so much of the indebtedness as is sufficient to satisfy the judgment.[8] Any payment made by the debtor of a judgment debtor pursuant to such an order is a discharge of his indebtedness. If there is any question concerning the indebtedness to the judgment debtor, a judgment creditor may commence an action against the third party, or may have a receiver of the property of the judgment debtor commence such an action.[9]

Any time after the institution of a supplementary proceeding the judgment creditor is entitled to have appointed a receiver of the property of the judgment debtor,[10] who then is vested with all the rights of property of the judgment debtor.[11] This includes real property from the time when the order of appointment is filed with the clerk of the county where such real property is situated.

Where it appears that the judgment debtor has income with which he might satisfy the judgment, the judgment creditor may procure an order directing the judgment debtor to pay to the judgment creditor such portion of his income, either earned or otherwise acquired, after due regard for the reasonable requirements of the judgment debtor and his family, as the court may direct.[12] This is a very effective remedy. Many judgment debtors having substantial incomes from salaries or trust funds formerly were able to avoid or delay for a long time the collection of judgments against them by applying only 10% of such income to the payment of their debts under garnishment orders. The present statute permits the application of further sums above the 10% to the payment of the debtor's debts.

Fraudulent Conveyances

Many debtors, in an effort to avoid their debts or to impede the collection of judgments against them, are wont to make transfers of their property for little or no consideration. The New York State Legislature, in 1925, adopted the Uniform Fraudulent Conveyance Act to deal with such conveyances (Article 10, Debtor and Creditor Law). Under this Article, a person is declared insolvent:

> "when the present fair saleable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."[13]

[5] *Civil Practice Act, Section 779.*
[6] Civil Practice Act, Section 781.
[7] Civil Practice Act, Section 782.
[8] Civil Practice Act, Section 794.
[9] Civil Practice Act, Section 795.

[10] *Civil Practice Act, Section 804.*
[11] Civil Practice Act, Section 807.
[12] Civil Practice Act, Section 793.
[13] Debtor and Creditor Law, Section 271.

The statute provides that:

> "Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."[14]

The statute also provides that conveyances made by persons in business without fair consideration[15] and conveyances made by a person about to incur debts[16] are fraudulent as to both present and future creditors. A conveyance made with the actual intent to:

> "hinder, delay, or defraud either present or future creditors is fraudulent as to both present and future creditors."[17]

The law gives creditors who have matured or unmatured claims the right to have the fraudulent conveyance set aside or the fraudulent obligation incurred annulled to the extent necessary to satisfy their claims,[18] and certain other rights and remedies.

Insolvency Proceedings

All of the remedies mentioned in the foregoing paragraphs have dealt with the rights of individual creditors to reach the assets of debtors. When the debtor is insolvent, his property, if liquidated, must be distributed ratably to all of his creditors, bearing in mind their respective priorities. He may therefore take steps to apply all of his assets to the payment of all of his debts, or some of his creditors may commence proceedings against him toward such end.

The proceedings which may be taken by a debtor are three-fold. He may transfer his assets by a common law deed of trust to a trustee to be liquidated by the latter and the proceeds to be paid over to the creditors ratably; he may make a general assignment for the benefit of creditors under the New York State Debtor and Creditor Law, in which case the New York Supreme Court supervises in a general way the administration of the "estate;"[19] or he may file a petition in bankruptcy in the Federal Court and place control over the proceedings in the local United States District Court.[20] The "estate" consists of all of the assets of the insolvent debtor which are turned over to the common law trustee, to the assignee, or to a receiver or trustee in bankruptcy, as the case may be. In all of these insolvency proceedings all creditors may file claims against the insolvent debtor and when the assets have been marshalled and liquidated, the proceeds are applied to the payment of all the debtor's debts ratably. The same is true in involuntary bankruptcy proceedings where creditors of an insolvent debtor file a petition in the Federal Court and have such debtor adjudicated a bankrupt.

Common Law Deed of Trust

A debtor has the right to transfer his assets to a trustee to be liquidated by the trustee and the proceeds paid over to his creditors. This may be done outside of court and depends for its effectiveness upon the unanimous consent of all the creditors. A creditor who refuses to accept payment may nevertheless proceed against the debtor to collect the full amount of his claim. This form of liquidation is sometimes used in the case of a small debtor with few assets and few creditors where the administration expenses of a court proceeding either in the

[14] Debtor and Creditor Law, Section 273.
[15] Debtor and Creditor Law, Section 274.
[16] Debtor and Creditor Law, Section 275.
[17] Debtor and Creditor Law, Section 276.
[18] Debtor and Creditor Law, Sections 278 and 279.
[19] Debtor and Creditor Law, Article 2.
[20] 11 U. S. C., Section 22.

State courts, under the Debtor and Creditor Law, or in the Federal bankruptcy courts, would dissipate all the assets.

Bankruptcy

An insolvent debtor has the right to file a petition in the United States District Court to have himself adjudicated bankrupt and have all of his remaining assets, if any, taken into custody of the Court and through the machinery of the bankruptcy court distributed among his creditors.[20] If he has been truthful in his petition and has been cooperative in the administration of his "estate," has not committed any frauds upon his creditors, and has not destroyed his books, if he had any, the bankrupt is entitled to be discharged of all the debts which he owed at the time he filed his petition.[21]

Creditors of an insolvent debtor have the right to file a petition in the United States District Court to have such debtor adjudicated a bankrupt and to have the assets in question taken into custody of the court for liquidation and distribution.[20] In order to be entitled to file such an involuntary petition three or more creditors must join where there are twelve or more creditors of the debtor.[22] The claims of the petitioning creditors must amount to at least $500.00. If there are less than twelve creditors in all, a single creditor to whom the debtor is indebted in the sum of at least $500.00 may file such a petition against the debtor. It must be remembered that the debtor may not be petitioned in bankruptcy merely by reason of his insolvency. Certain "acts of bankruptcy" are required to have been committed by the insolvent debtor in order to permit his creditors to file such a petition. The Bankruptcy Act defines these "acts of bankruptcy" as follows:

"Acts of bankruptcy by a person shall consist of his having (1) conveyed, transferred, concealed, removed, or permitted to be concealed or removed any part of his property, with intent to hinder, delay or defraud his creditors or any of them; or (2) transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditor over his other creditors; or (3) suffered or permitted, while insolvent, any creditor to obtain a lien upon any of his property through legal proceedings and not having vacated or discharged such lien within thirty days from the date thereof or at least five days before the date set for any sale or other disposition of such property; or (4) made a general assignment for the benefit of his creditors; or (5) while insolvent or unable to pay his debts as they mature, procured, permitted, or suffered voluntarily or involuntarily the appointment of a receiver or trustee to take charge of his property; or (6) admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt." (11 U. S. C., Sec. 21).

One of the main reasons why creditors file petitions in bankruptcy against debtors is to take steps to set aside preferences made by the bankrupt to creditors within four months of the filing of the petition.[23] The Trustee in Bankruptcy may not only proceed to set such transfers aside, but, availing himself of Sections 67 and 70 of the Bankruptcy Act,[24] may undertake proceedings to set aside fraudulent conveyances. The Trustee has all of the powers that any creditor or group of creditors may have in bringing back to

[21] 11 U. S. C., Section 32.
[22] 11 U. S. C., Section 95 b.
[23] 11 U. S. C., Sections 96 a and 96 b.
[24] 11 U. S. C., Sections 107 and 110.

the bankrupt's estate any property dissipated prior thereto.[25] Such a petition must be filed within four months after the commission of the act of bankruptcy. The debtor is entitled to a discharge of his debts in involuntary bankruptcy the same as in a voluntary proceeding.

Chandler Act

There were added, recently, to the bankruptcy statutes two chapters which deal with the reorganization of the affairs of a bankrupt. These are known as Chapters 10 and 11 of the "Chandler Act." Under Chapter 10 a corporation may apply to the Federal Court for a reorganization of its affairs.[26] This involves a *complete* reorganization and readjustment of its capital and other assets under the jurisdiction of the Federal Court. If the liabilities of such a corporation exceed $250,000.00 the Court must appoint a Trustee to take over the assets of the corporation during the pendency of the proceedings. Under Chapter 11 the debtor, whether a corporation, partnership or individual, may apply to the Court for confirmation of a plan of arrangement whereby the debtor may reduce the amount payable and get additional time to pay.[27] The Court will confirm such a plan if it finds that it is fair and equitable to the various classes of creditors. Debtors who have filed petitions in bankruptcy voluntarily, or against whom petitions in involuntary bankruptcy have been filed, have the right to apply for relief under the reorganization statutes of the Chandler Act. If in such cases the applications for reorganization are rejected the ordinary bankruptcy proceeds as though the applications had never been made. Upon approval of the plans, the debtor's obligations are limited to the extent that the Court has approved the plan.

[25] 11 U. S. C., Section 110 e.
[26] 11 U. S. C., Sections 501-676 inclusive.

Consigned Goods and Reclamation Proceedings

Creditors sometimes find it expeditious to deliver goods to their customers "on consignment," intending thereby to retain title to the goods in themselves, so that in the cases of the debtor's insolvency the creditors may reclaim their goods and thereby save themselves from loss by reason of the debtor's insolvency. However, it is important to remember in this respect that merely labelling a transaction as a delivery on consignment does not make it so where the intention of the parties really is for a sale of the goods to the debtor and the transfer of the title to the debtor. If a transaction labelled as a consignment is in fact a sale, the creditor cannot reclaim the goods on the debtor's insolvency for the goods belong to the debtor and become part of his estate which is distributable to all creditors ratably.

Goods actually delivered to a debtor on consignment and all other property which may be found on the premises occupied by the bankrupt but which in fact belong to third parties, may be reclaimed by them in appropriate proceedings in the bankruptcy court known as "reclamation proceedings." In effect, these are similar to replevin actions in the State courts.

Bulk Sales

Under the New York State Personal Property Law a debtor has the right to sell all or a part of his assets in bulk only upon complying with certain requirements[28] which are, briefly, these:

Notice must be given to all of the creditors of the seller by registered mail at least ten days prior to the date of the proposed sale and an inventory must be delivered by the

[27] 11 U. S. C., Sections 701-799 inclusive.
[28] Personal Property Law, Section 44.

seller to the proposed purchaser showing in detail the goods sold and their cost. The purchaser must retain this inventory for at least 90 days after the date of sale and all creditors have the right to examine the invenotry. If no adequate notice is given to creditors or if the inventory is not delivered as required, the purchaser may be declared to be the Trustee of the goods for the benefit of all creditors of the seller. If a proposed bulk sale will render the seller insolvent, creditors, of course, have the remedy mentioned above to treat the proposed sale as a fraudulent conveyance and to take steps accordingly to protect their rights.

It is the writer's hope that the foregoing has served to give some little enlightenment to the reader concerning the rights of a creditor in the collection of debts owing him. It has necessarily been extremely cursory, but it is hoped that sufficient is therein contained to help creditors decide upon appropriate legal channels in the protection of their rights.

Fiduciary Accounting

THE papers which follow were presented at a special technical meeting on the evening of April 9, 1941, at the Engineering Auditorium, 29 West 39th Street, New York City under the direction of the Committee on Fiduciary Accounting, of which Archie F. Reeve is Chairman.

Changes in the Tax Laws Affecting Estates and Trusts

By HARRY COOPER, C.P.A.

The purpose of this discussion is to briefly review the changes during 1940 and 1941 to date in the tax laws affecting estates and trusts, and to point out a few of the significant court decisions with reference to this group of taxpayers. Reference will first be made to the Federal estate and income tax laws and then to the corresponding New York laws.

Federal Estate Tax Law

In 1941, the only change(1) made by Congress in the Federal estate tax law clarified cross-references within the Internal Revenue Code. In 1940, Congress added Section 951 which levies a national defense tax of 10% of the taxes which would otherwise be payable. The new tax is not reduced by the 80% credit allowed for death taxes paid to States, territories and possessions of the United States. The additional 10% tax is effective for a period of five years starting with June 26, 1940. There were no other changes in the law in 1940 and 1941.

Significant court decisions interpreting the law and changing it from what most of us thought it meant have been more numerous. Several of the decisions have already been reflected in amendments to the estate tax regulations. Some of the more important decisions and changes in the regulations will now be discussed briefly.

Article 11 of Regulations 80 provides that where an estate elects to value its assets as of one year after the decedent's death, the income for the intervening year must be included as part of the gross estate. On March 3, 1941, the Supreme Court in Maass *v.* Higgins reversed decisions of the lower courts which had sustained these regulations. Accordingly, where an estate elects to use values as of the optional valuation date, the interim income is to be excluded.

There have been important changes in the regulations(2) with respect to life insurance payable to beneficiaries other than the estate. Under the amended regulations, generally all such insurance will be included in the insured's estate if he directly or indirectly paid the premiums, even though he had relinquished all legal incidents of ownership in the policy. There is one exception, in the case of an insured who, prior to January 10, 1941, the date of the revised regulations, irrevocably transferred an insurance policy, and who since that date has never possessed any of the legal incidents of ownership therein. In that case there will be taxed only the proportion of the proceeds of such policy attributable to premiums paid by the insured after January 10, 1941.

Now the important factor is: Who paid the premiums? The possession of the legal incidents of ownership in the policy is largely ignored. It would appear that to the extent the amended regulations attempt to tax insurance where the insured continued to pay premiums but relinquished all the legal incidents of ownership, their validity may be

questioned. Of course, the $40,000 insurance exemption applies to policies payable to named beneficiaries.

Other changes[3] in the regulations do not warrant discussion at this time.

Two other decisions deserve some comment, the ruling in the Hallock[4] case is of substantial interest. The court there held that the mere retention of the possibility of reverter in a trust subjects the principal of the trust to Federal estate taxes, thus upsetting precedents and decisions of many years' standing.

In the Maguire case the Supreme Court ruled on March 31, 1941[5] that the basis of property acquired by general bequest from a testamentary trust was its value at the time of delivery of the property by the executors to the trustees, rather than its value when distributed by the trustees to the taxpayer. The decision was under the 1928 and 1932 acts, which differ from the 1934 acts and subsequent laws. The court has before it cases[6] involving the same question under the 1934 act.

Federal Income Tax Law

The net income of estates and trusts is computed in the same manner and on the same basis as in the case of an individual, with the following exceptions: (a) Contributions may be unlimited if provided for in will or in deed of trust, (b) a credit is allowed against the net income for amounts distributable to beneficiaries. The 1940 Revenue Act made no change in sections 162 to 170 of the income tax law pertaining solely to estates and trusts, and no changes have been made in 1941 to date by the present Congress. There have been, however, a number of significant decisions in income tax cases which affect estates and trusts.

There were several cases affecting the deductions that may be claimed by fiduciaries during the period of their stewardship. Section 23(a) provides that "in computing net income there shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". In the case of Higgins v. Commissioner[7], involving an individual with extensive investments, the Supreme Court held that the taxpayer's activities in the management of his securities did not constitute carrying on a business. As a result of the decision, the Commissioner reversed previous rulings[8] which had allowed the deduction of ordinary and necessary expenses with respect to the management, protection and conservation of properties producing taxable income. There is accordingly some doubt as to the deductibility of fiduciary's commissions and other expenses. Further light will be shed on this matter shortly, since there is now before the Supreme Court the case of the Pyne Estate, in which the Court of Claims[9] held that attorney's fees and expenses were deductible since the executors were in the business of conserving the estate and protecting its income, and the case of the Duke Trust, where a Circuit Court[10] held that trustee's commissions were not deductible since the trustee was not carrying on a trade or business. Possibly the Supreme Court, in making its decisions, will draw a distinction between an active trust—such as the Pyne Estate—and an inactive trust, such as the Duke Trust.[10a]

There have been several cases involving the question of whether income distributed by a fiduciary was taxable to it or the distributee. The regulations[11] state that "if the tax has been properly paid on the net income of an estate or trust, the net income on which the tax is so paid is not, in the hands of a distributee thereof (the legatee or the beneficiary), taxable as income to him". In the Garret[12] case, the Com-

missioner attempted to apply the rule that distributions to a distributee under such circumstances were distributions out of the current year's income of the fiduciary (to whom a deduction for the distribution was allowed) and asserted a tax against the distributee on such income. The Board ruled against the Commissioner and stated that the question is one of fact as to whether the disbursements were from the income of earlier years or of the taxable year. In the instant case the fiduciary identified the source of the payments to the beneficiaries by marking the vouchers. The fiduciary also kept separate accounts for each year's income and the disbursements therefrom to the beneficiaries. The Board held it was not necessary to show complete separation of the income of earlier years into bank accounts separate from that of the taxable year. Other cases[13] with reference to distributions to residuary legatees have also been decided in favor of the beneficiaries.

A decision[14] of particular interest to accountants, attorneys and other professional men was handed down by the Supreme Court on March 31, 1941, with reference to the accrual of a partner's share of the income of a partnership to the date of his death. The court held that though the partnership was on a cash basis, Section 42 required that a deceased partner's interest in his firm's collectible accounts receivable and in fees earned in whole or in part but not billed to clients, should be included in the decedent's income.

Many creators of short-term trusts found that all their efforts at tax minimizing had gone for naught when the Supreme Court, in the Clifford[15] case, taxed to the grantor the income of an irrevocable term trust. The basis of the decision was the short duration of the trust, the fact that its beneficiary was the wife of the grantor, and, most important, the fact that the grantor retained control of the trust principal. Incidentally, the decision was based on Section 22(a) which embraces a general definition of taxable income and was not based on the sections relating to revocable trusts.

New York Tax Laws

In 1941, the New York estate tax law was amended[16] to extend for another year to June 30, 1942, the increased rates of emergency tax on estates of decedents. The emergency tax rates are the same as the Federal "basic estate tax" rates under the Revenue Act of 1926. Another amendment[17] extended the deduction for charitable gifts to include bequests to officers of religious denominations, subject to the same conditions and exceptions applicable to a religious corporation.

In 1940, the estate tax law was amended to eliminate the provision [18] for credit against the New York tax for death duties paid to other States or territories of the United States. Other changes[19] in the law in 1940 were minor in nature.

New York generally follows the Federal government in estate tax matters, and so it is reasonable to assume that changes made in the Federal law will soon find their counterpart in the State law.

The only change[20] made to this date in 1941 in the New York income tax laws affecting estates and trusts related to employers' pension trusts and confined tax exemption to those trusts whose funds may not, prior to termination of the trusts, be devoted to purposes other than the benefit of the employees. There were no changes in 1940 in the specific sections dealing with estates and trusts under Article 16 of the State tax laws.

Conclusion

The more important changes in the law in the last year have not

been the result of legislative action but of judicial construction. These court decisions have opened up new problems in connection with provisions of the law whose meaning we thought were well settled. The development of such matters under the new decisions is still in the early stage. Under the circumstances, accountants should be alert to keep posted on future changes.

Citations

(1) Public Law 18, 77th Congress (1941), approved Mar. 17, 1941

(2) Art. 25, 26, 27, by T. D. 5034, Jan. 10, 1941

(3) Art. 13, 16, 72 by T. D. 5042, 4966, 4991, respectively

(4) 60 S. Ct. 444

(5) Maguire *v.* Com., S. Ct. No. 346, Mar. 31, 1941, and others

(6) Helvering *v.* Reynolds, 114 Fed. (2d) 804

(7) Feb. 3, 1941

(8) I. T. 3452, I. R. B. 1941-8-10616, page 4

(9) 35 Fed. Supp. 81

(10) 112 Fed. (2d) 457

(10a) On April 28, 1941, the United States Supreme Court affirmed the *Duke* decision. It aso vacated the decision in the *Pyne* case holding that the activities of an executor in marshalling and gathering assets for ultimate distribution do not constitute a trade or business

(11) Art. 19.162-1

(12) Garrett, 43 B. T. A. No. 89

(13) Durkheimer *v.* Com. 41 B. T. A. 585; Wilcox *v.* Com. 43 B. T. A. No. 134

(14) 112 Fed. (2d) 919

(15) 60 S. Ct. 554

(16) L. 1941, C. 135, approved Mar. 20, 1941

(17) L. 1941, C. 118, approved Mar. 17, 1941

(18) L. 1940, C. 138, effective Mar. 10, 1940, repealed Sec. 249-o

(19) L. 1940, C. 146, amended Sec. 171, Art. 8; C. 586, amended Sec. 249-cc; C. 131 amended Sec. 249-n

(20) L. 1941, C. 67, effective Mar. 7, 1941.

Apportionment of Foreclosed Real Estate As between Capital and Income

By Chester A. Allen, C.P.A.

Subconsciously at least all of us strive for simplicity—simplicity in business, in the law, understandable simple terms from our doctor—the simple life. In the struggle to find simplicity in the rules for the apportionment of proceeds of foreclosed real estate, our State Legislature passed Chapter 452 of the Laws of New York on April 13, 1940. In looking around for a text for this talk, I found what seemed to be an ideal model of simplicity. This little poem comes from an actual case in our Kings County Surrogate's Court, File No. 1630 in the year 1927. It is the Will of a Brooklyn undertaker named Edwin Bayha:

> All my earthly goods I have in store
> To my dear wife I leave forever more
> I freely give—no limit do I fix
> This is my Will—she the Executrix.

But, just as Chapter 452 does not fully simplify things, I found out that this simple little text of mine was not just as simple as it seemed to me. In talking it over with an attorney friend—some of you may

know him—Sydney Soons, who does a lot of probate work—he said: "Well, the will was probably all right for some one who lived in Brooklyn. He would not be likely to have property in another State. But if property were owned in another state, I would find that I would have difficulty there, and undoubtedly have to file a bond to get possession of the assets. Calvin Coolidge's Will (continued Mr. Soons) was even shorter than your poem—23 words, leaving everything to Mrs. Coolidge. Calvin forgot, though, to name her as executrix, so she had to qualify in a separate proceeding, and give a bond."

We accountants must, I guess, just be satisfied that the law is not an exact science, and be thankful for the help towards simplicity given by Section 17-c of the Personal Property Law.

Before I go further, I must first note and leave in your mind that a will-maker, or the grantor of a trust fund, may make such provisions as he wishes, and those provisions will control in place of any of the rules of the Courts or of the Statutes which I am about to take up.

Trustees had had no serious trouble with the handling of foreclosed real estate for a period of thirty-five years—that was the time between the decision in the Matter of Meldon vs. Devlin, affirmed by our Court of Appeals in 1901, and the decision in the Matter of Chapal. When the real estate troubles started with a vengance in 1932, with the Superintendent of Insurance taking over the mortgage guaranty companies, and suspending payments under their guarantees, with trustees revoking or releasing the guarantees and getting control of the mortgages, and with foreclosure after foreclosure, a most serious problem and a most complex situation arose. Income which had come in with the regularity of the seasons was stopped; good securities had to be sold, and their income of course stopped, in order to provide costs involved in foreclosing mortgages. Life tenants had no right to receive the net income from foreclosed properties until they were sold. The acquisition of so much property by trustees, with their efforts to make sales, accelerated the decrease in real property values, and made harder and harder the task of making any sales. The old rules had never been intended for such an avalanche of foreclosures, and for such serious results to life tenants. Great credit is due to the Surrogates of our own City, and out in Nassau County, for the intensive work they did which made possible the final decisions of our Court of Appeals in the *Matter of Chapel 269 N. Y. 464,* and the *Matter of Otis 277 N. Y. 101.* Later, these same Surrogates made specific decisions clarifying and interpreting the policies laid out by the Court of Appeals. The principles as finally determined were simple, and, once the figures were all in, quite easily worked out. I think it is an honor to our Society that one of our own members—Orrin R. Judd—in an article published in the February, 1938 Bulletin, laid out a comprehensive, accurate and nevertheless simple formula whereby the apportionment could be worked out. Counsel for the bank I serve, as well as we in the bank itself, have used this formula of Mr. Judd's since it was first published.

> Aside: It is going to be hard on us, and on our counsel, if I should now find that Mr. Judd belongs to ASCAP, and we have to pay him royalties for each case in which we have used his formula.

As to what I will call "old" mortgages—those not subject to the brand new rules of Subdivision 1st of the new statute, the Chapal-Otis rules,

with but a simple modification, are still in force, and will be controlling for many, many years to come. Mr. Judd's formula, with but slight modification, will still be of service in apportioning the proceeds of foreclosed real estate between income and principal.

Under the Chapal-Otis rule, the life tenant was not entitled, as a matter of right, to one cent from the rents of the property, no matter how well rented the property might be, until after the property had been sold. Principal was called upon to advance all sums needed in connection with the foreclosure expenses: lawyers fees, back taxes, and the penalty interest on the taxes, and the like, and was also called upon to advance any moneys required because of deficits in the operation of foreclosed real property. Where operated at a profit, net rents were first used to repay principal advanced, and then impounded pending eventual sale of the property. At the time of such sale, the proceeds from the sale, plus net rents, were divided:

FIRST: The advances from principal for foreclosure expenses and taxes to date of foreclosure, for capital expenditures on the real property, and for operating deficits, were refunded in full. If the net cash received on the sale was not sufficient to make this refund, principal then had a first call upon the collections of the purchase-money mortgage until the balance of all advances had been paid in full.

Remaining cash, if any, and the balance of the purchase-money mortgage, were apportioned between principal and income in the ratio of the face amount of the mortgage to the total amount of interest at the rate called for in the mortgage, from the date of default to date of sale. Many pieces of foreclosed real property could not be sold for a number of years. AS A MATTER OF FACT, many pieces of foreclosed real property are still on the books of the trustees, although foreclosed back in 1933 at the beginning of the mortgage troubles. The application of the Chapal-Otis rule certainly worked a hardship on the life tenant in every case where the real property was income-producing. The Court of Appeals did grant permission to the Trustee, in its discretion *and at its risk,* to make distributions to the life tenant from net rents but only after all advances from principal had been repaid. This discretion was rarely exercised. This hardhip on widows and children of testators who had left their estates in trust is undoubtedly one of the prime reasons behind the adoption of Section 17-c of the Personal Property Law. This new law was advocated by the Executive Committee of the Surrogate's Association.

Let us now consider the first subdivision of Section 17-c of the Personal Property Law. This subdivision applies to:

A: As to trusts created after April 13, 1940, or trusts under wills of persons dying after April 13, 1940:

(a) Applies to all the mortgage investments which may have been received with the estate of the decedent, or from the grantor of the trust, regardless of the fact that these mortgage investments were made prior to date of the passage of the Act.

(b) Applies to any mortgage investment made by the Trustees.

B: As to trusts in existence before April 13, 1940, whether voluntary or testamentary trusts:

(a) Applies only to investments made by the Trustees after April 13, 1940.

Eventually, but far, far in the future, when all of the old mortgages shall

have been collected, and all of the old foreclosures sold, this section of the law will be the only part having any practical effect.

As to the mortgage foreclosures coming under this subdivision, an entirely new rule is created. The Chapal-Otis rules are done away with. The mortgage investment will disappear from the assets of the trust, and the real property acquired will take its place. The amounts paid for foreclosure expenses, and for taxes and the like, up to date of foreclosure, will be principal charges. They will never be repaid in part or in whole, from rents or income. The cost of all capital improvements is chargeable to principal, and not recoverable from rents or income. In the Estate of West, Surrogate Foley, as I read his decision, considers the cost of putting a premises in repair and in tenantable condition as a "cost of capital improvements". I think the accountant might here add some thoughts of his own in advising trustees. There are intimations in earlier decisions as to amortization of capital improvements. While it would appear quite clear that the first cost of putting a premises in repair, and in tenantable condition, may be charged to the capital account, I would think that any later charges to the capital should be amortized on some conservative and logical basis. A change of a capital nature, made for example in order to obtain a tenant on a long lease, might well be written off against income over the life of the lease.

This matter of decision between charging repair and rehabilitation to principal or income still leaves room for the need of advice from accountants. Many interesting problems will arise. I wonder what the decision would be in a case of the cost of repairing a bathroom floor which gave away while one of our tenants was in the tub, precipitating him, with the tub and the water and the soap-suds, half-way between the floor and the ceiling of the apartment below.

I would not want to be the trustee who is trying to explain to the attorney for an income-beneficiary the charge that tenants had been given more than they needed, in fact more than they asked for. This letter, which I vouch for as a real one, illustrates in a humorous way the problems of absentee real estate management.

* * * * *

Now, as to the second subdivision of the new law:

This subdivision of Section 17-c applies:

A: As to trusts created after April 13, 1940, or trusts under wills of persons dying after April 13, 1940:

(a) Subdivision 2 does not apply to any possible mortgage holding of these trusts.

B: As to trusts in existence before April 13, 1940, whether voluntary or testamentary trusts:

(a) As to foreclosures completed prior to the passage of the Act, where the property had not been sold up to time of passage of the Act.

(b) Foreclosures started but not yet completed at the time of passage of the Act.

(c) Foreclosures started after passage of the Act in connection with mortgage investments made prior to April 13, 1940.

(d) Reforeclosure of purchase money mortgages in connection with any operations governed by the Chapal-Otis rule, or subdivision 2 of Section 17-c of the Personal Property Law.

A simple way of remembering all four of these subdivisions is to say that subdivision 2nd applies to foreclosures resulting from any mort-

gage investment in these "old" trusts where the investment was made prior to April 13, 1940, except however that no portion of the new law applies to foreclosures, where the resultant real estate had been sold prior to April 13, 1940.

The subdivision does not do away with the Chapal-Otis rules. It merely modifies their application. It makes mandatory the payment to life tenants of 3% income, when earned, and without regard to the repayment of principal advances, instead of leaving such payments to the discretion and at the risk of the Trustee. However, at the end of the salvaging operation such amounts paid from year to year are deducted from the share of income apportionable to the life tenant. It is not at all unlikely that there will be some few cases where this payment of 3% out of net rents will result in giving income more than it should have received. In paragraph 2544 of Bradford Butler's book illustrations are given of situations which would result in giving income a larger share than it would receive under the free application of the Chapal-Otis rules. The new statute distinctly provides that such surplus, whenever it occurs, is not recoverable from the life tenant, nor is it to be surcharged to the Trustee. In such cases, principal does lose to the extent of the surplus payments to income.

This subdivision continues the rule that all moneys advanced from principal, whether in connection with foreclosure, for capital expenses, or for losses in operation, must be repaid in full before the balance of the proceeds is apportioned between principal and income. However, the payments to income up to 3% of the face value of the mortgage are to be made regardless of the fact that advances have not been repaid to principal.

The 3% shall be based upon the annual income of each property, and not upon income for the entire period. The result of the operations of each parcel for each year must be treated as a separate entity.

The anniversary date of the computations for determining the annual payments to income is the date of the acquisition of the real property, a fiscal year for each separate foreclosure, and not a calendar year.

From the time Section 17-c was adopted, right down to the present time, lawyers still discuss the possibility that subdivision 2nd may not be constitutional. Surrogate Foley, in his decision in the Matter of West, holds section 17-c to be constitutional in every respect. The Surrogate finds that it does not impair substantive rights, but that its provisions are merely remedial, procedural and administrative. He states that the Act does no more in modifying existing rules than the Courts themselves could do and have done within their constitutional powers.

However, there is still discussion among attorneys as to the possibility that the law does impair vested rights of remaindermen.

It would be the accountant's duty to make sure that the trustee or the attorney he is advising has considered this question. Beyond that, however, the accountant should follow the instructions he is given. I would think that the chance of finding that income has been overpaid upon completion of the salvaging of any property is very, very small. If the property earns enough to throw off 3%, it ought to bring in a price sufficient to keep it out of the classification of any of Mr. Butler's examples. I have given thought, however, to the possibility of surcharge to a trustee on an interim account. Assume advances of several thousand dollars, and a property earning 3% or less each year. Under the Chapal-Otis rule, which would be

the controlling rule if 17-c is held to be unconstitutional, the trustee would be required to pay back advances before he is permitted to use his discretion in disbursing income. Under the new statute, the Trustee pays out all of the net earnings each year. He has repaid nothing to principal. Upon an interim account, if section 17-c is unconstitutional, a remainderman would have a claim that the Trustee had not followed the Chapal-Otis rules, because he had not first repaid to principal the amount of advances. This would be so regardless of the fact that at some later date, when the property is sold, it might turn out that income had not received any more than it was entitled to. It is my very strong hope, and also my personal belief, that the opinion of Surrogate Foley will be sustained at such time as we get a case which is reviewed by the higher Courts. Until such time comes, though, I feel it to be the accountant's duty to call to the attention of the one he serves the possibility of this unconstitutionality in connection with subdivision 2nd.

To Summarize:

Real property acquired by the foreclosure of any mortgage investment, whether old or new, in trusts created after April 13, 1940, is not subject to the Chapal-Otis rules. Investments newly made after April 13, 1940 in old trusts are not subject to the Chapal-Otis rules.

These matters will be handled in estates and trusts in much the same manner as an accountant would handle them on the books of a business man: The mortgage disappears, and in its place comes a piece of real estate, carried at a cost value made up of the unpaid face amount of the mortgage, all foreclosure costs, and capital expenses. This value is measured against net sales value to determine the eventual profit or loss on the realization of the asset. Principal receives all of such profit, and must bear all of such loss. Income gives up its right to the interest accrued to date of foreclosure, and its right to share in the eventual proceeds of the sale of the real property. Instead, it receives all of the net rents, and must stand any net losses in the operation of the property.

As to trusts in existence before April 13, 1940, and exclusive of investments made for such trusts after that date, we still follow the Chapal-Otis rule, with two exceptions:

(1) We do not wait to make payments to the income tenant until all principal advances have been repaid;

(2) The income tenant is entitled to receive, as a matter of right, 3% of the face value of the foreclosed mortgage so far as that amount is earned each year. The amount so paid is treated as an advance on account of income's eventual share, and deducted from the amount otherwise apportionable to income at the completion of the salvaging operation—the sale of the real property.

Only in the probably rare event that the amount apportionable to income under the regular Chapal-Otis rules is less than the amounts actually paid on the 3% annual basis, or in the event of a sale with cash insufficient to repay principal advances and with a reforeclosure of the mortgage before it has amortized to a point where these advances have been repaid, will principal stand to receive anything less than would have been allotted to principal under the Chapal-Otis rules before the modification of the Statute.

Fiduciary Accountings—Their Need and Frequency

By Archie F. Reeve, C.P.A.

To many a layman, a fiduciary may be the title of a person whose job and duties are quite a mystery. A friend of mine said that he noticed an item in a North Carolina paper to the effect that I was to talk tonight on some kind of animal. He thought a fiduciary was something ferocious.

The large and ever increasing number of laymen acting in a trust capacity should also become familiar with the word and, still more important, with the procedure or steps they should take as a safeguard in connection with the duties and obligations they have assumed when appointed as executors or trustees under a will, deed, or by a court appointment.

The Webster dictionary describes a fiduciary as a holder of trust or confidence, from the Latin word "fiducia", meaning trust or confidence.

The tremendous general growth of wealth and property among the families throughout this country, and the fact that no satisfactory method has been discovered of taking such wealth with you when you die, has tended to make accounting for estates and trusts assume an increasing importance in the last two decades. By means of a will or trust you can at least be sure your life savings are not dissipated but used nearly as you direct.

The fiduciary is responsible to many. He must account to the Surrogate's or Supreme Court on his trusteeship, prepare annually fiduciary tax and information returns for the Federal and State governments, and be prepared to inform beneficiaries as to their interests. If an executor, he must pay Federal or State estate inheritance taxes.

The document or report of the fiduciary prepared for submission to the courts or beneficiaries showing his conduct of the trust, is termed an "accounting". It would seem natural that an accounting be prepared by an accountant, as the former is described as "a statement of business dealings subjected to a reckoning or review" and "a statement of accounts, or the debits and credits in financial transactions". Despite this description, for a great many years the accountings of executors and trustees have been considered and presented as legal documents. Each Surrogate's Court has a certain form of account to be followed.

Some accountants urge that five years is too long a period between accountings. If there were matters to be corrected or claims to be made and the work was not started until after the five years had elapsed, there might be a question as to whether it could be finished and claims made before the end of the limitation period.

It is true that when it comes to arranging figures, preparing statements, showing financial results, etc., the expert accountant should ordinarily be competent to produce a most satisfactory job. With the executor or trustee, it is necessary to prepare accounts in accordance with prescribed forms adopted by the Surrogate's or Supreme Court of the various counties or districts of the various States. For such reasons, and because the preamble or presentation of accounts contains legal wording and data, it is advisable for the accountant, when asked to prepare accounts for the executor or trustee, to cooperate and work in conjunction with the said executor's attorney.

Therefore, if an accountant is engaged by an executor or trustee, the writer believes it would be best to

seek out the attorney for the estate or trust and consult with him. He has always found them perfectly willing to cooperate in jointly serving the client. In most jurisdictions it is required that an account contain a list of beneficiaries with their several interests in the property. The determination of such beneficiaries sometimes involves the application of legal principles, making another reason for retaining a lawyer.

We find, in some instances, that accountings which have been prepared according to public accountants' views as to form and sometimes as to content, do not always satisfy the lawyer or the court. It seems best to find out what form of account is preferred in the county Surrogate's Court before heading up schedules. The forms of the various courts, while differing somewhat, are in most respects similar. In New York County, the Surrogate's Court's requirements as to form are most exacting.

An executor and trustee should always keep in mind that eventually an accounting must be prepared, and it is very important that the said executor or trustee have his records started properly and see that they are well maintained. Quite often, trustees or executors do not immediately make such arrangements, with the result that many years elapse. When an accounting finally has to be made, it develops that entries were not properly handled in the first instance, capital items were inadvertently mixed with income, income was overpaid, debts of the decedent were not properly set up, and the terms of the will not strictly adhered to or caried out. All this would necessitate adjusting or correcting entries, and in case income was overpaid there might be serious difficulties. Income overpaid is always hard to recover, it seems. People who save money received from inheritances are undoubtedly scarce.

The trustee should, as a matter of course, keep capital and income apart, and account for these two items separately. If a trustee does not realize the importance of doing this, he may find himself in a difficult position and subject to surcharge—that is, the making good out of his own pocket for losses the estate or trust suffered by the trustee's errors or omissions.

Without doubt a bank or trust company can serve the trustee in his work, and are often chosen as custodian and co-trustee.

In some cases, the assets are such that they would be turned over to a real estate management company who specializes in renting property and collecting rents, etc. Where the assets are mixed, it is apparent that the books should be maintained in the trustee's office and periodically audited to correct any errors and make necessary adjustments. In these, as well as in the larger estates and trusts, it is found that the accountant as well as the lawyer has distinct services to render. Some of these are explained in the following sentences.

In cases where minors are beneficiaries, the court in judicial accountings is wont to appoint special guardians, whose duty it is to check up on the executor or trustee to see that the minor, whose interests he is protecting, receives all that is due him, and that no errors have been made which will decrease the value of such beneficiaries' interests. Incidentally, most clients when possible like to avoid having these special guardians because they usually put in terrific bills.

An executor or trustee, receives pay for his services from time to time. This is not stated as a salary but is termed a commission or fee,

because a commission is generally based on the value of the assets turned over to the trustee. It would be difficult for a man to estimate the proper compensation for handling his estate after death, as he could not anticipate its future value. The statutes or the courts have decided from time to time what the rates or amounts should be.

The rates the trustees will receive as commission are sometimes mentioned in a deed of trust, or will; but a trustee in New York State, I understand, can waive such commissions under certain conditions, and in their stead accept the statutory rates. Also, if no commissions are mentioned, the court may by decree state them, and in such case the usual statutory rates apply.

However, it is not always a simple matter for the executor or trustee to receive his compensation. As a matter of fact, an accounting is generally a prerequisite to receiving compensation because such a document forms the basis and sets forth the amounts and values the executor or trustee is charged with, as well as showing just how such values were arrived at. Incidentally, it also shows how well or how poorly the trustee performed his trust.

Trustees usually take their commission on income each year rather than have it accumulate, and accounting records are needed to make this calculation. This is termed an "annual rest" basis. Commissions on income are sometimes lost if not taken at the proper time.

Frequent accountings seem desirable in view of the fact that the Statute of Limitations may enter into the matter, and if the trustee had any claims (against third parties) that were not made within the time prescribed, a loss to the trust may result. There are those who believe every three years is long enough to wait before having an accounting prepared. It must be remembered that if the accountant prepares his schedules every five years it is just as well to have them in proper accounting form for presentation to the court. Therefore, they would be signed and sworn to by the trustee or trustees who were alive and able to sign at the time the account is drawn.

It sometimes happens that trustees resign or die, at which time an accounting should be made, and it is generally best to have these matters cleared up in letter-perfect form while the responsible trustee is available. The fact that the accounts are fully prepared and the various schedules and affidavits signed does not necessarily mean that they have to be filed with the court. They can be preserved in the trustee's possession for future filing at any time, or they can be attached to a receipt-and-release, according to the existing conditions.

In the case of one trust established about twenty years ago which never had an accounting, the books or journals maintained by the trustee in the first few years of the existence of the trust were lost in moving. There was, therefore, a lapse of several years without book records. It was necessary to go to the brokerage records for the years in question, where it was found that several brokers had, in the meantime, gone out of business and their records not available. It was then found necessary to build up the account from data on tax returns which were unfortunately not in detail, and some of the data was obtained from statistical records on income, etc., requiring an investigation which took some time. The writer has often wondered what the trustee would do in the event all data were missing. Apparently the courts do not prescribe uniform laws as to books, records, and accounts of executors

and trustees, and there are no specific penalties. An interested party can, of course, apply to the court for an accounting.

It is suggested that the accountant, when opening the estate books, obtain a copy of the State inheritance tax return or the inventory and appraisals of the various assets. While it is well to set these up on the books, it is also advisable to show the value, at date of death, of each security tentatively, as the values are sometimes changed before final determination by the taxing authorities. You may find that the Government deems the assets worth considerably more than can be realized. Having in mind that the accounting for the Surrogate's Court is to be prepared and submitted to the Court on the basis of date-of-death values, as determined for State inheritance tax purposes, it may be best in some cases to set these values on the books (as soon as known), and if the Federal estate inheritance tax return figures differ such values may be noted on the books as a guide and help when preparing income tax returns involving gains and losses on the sale of assets. There is also the question of depreciation as a deduction from income taxes. This, however, does not enter into the court accounting.

The executor or trustee has a duty to watch over the assets and see that he receives for the beneficiary all dividends, interest or other income due thereon. Usually his powers permit him to change investments, and he should periodically consult those competent to advise him in such matters.

One of the most important reasons for promptly starting a set of books for an estate is that the accountant may apprise the executor as to the amount of taxable income received during the first year so that the executor may save the estate the payment of unnecessary income taxes. After payment of expenses properly deductible from income, it is sometimes advisable to distribute a good portion of the income to the beneficiaries, leaving a reserve for possible adjustments.

Another advantage of a proper set of books is that the books will have a separate account for each beneficiary. Such accounts will enable the executor to watch payments to them and see that they receive their proper percentage of capital and income distributions. It may be necessary or advisable to change the investments, and it is evident that it is much easier to watch all assets when proper books are kept. An account for each security or asset should be maintained, showing date acquired, cost, etc., as well as any changes of capital on one hand and all income and expenses on the other. This is in reality mandatory, because when an accounting is made it should show the capital changes of each asset as well as the income and expenses of each asset. When stock dividends are received or changes in capital of companies occur, it is often necessary to determine which part of the dividend belongs to capital and which to income.

Conclusion

The accountant retained should:

1. *Consult with the estate counsel*—then set up the assets of the estate or trust on the ledger at the values as of date of death, including any accrued income as principal. Also set up the debts of the decedent as a liability. A full set of books is recommended, not just a check book.

2. Maintain capital and income accounts and see by audit that they are correctly debited and credited.

3. Have a subsidiary account for each asset so as to record increases or decreases or changes of the investment principal as well as check the income to see that all is received.

4. Inspect and check the legal documents, such as the transfer tax appraisals, will, deeds of trust, for guidance as to the correct accounting and the determination of various beneficiaries' shares.

5. Examine and audit vouchers for all disbursements and see that they are properly charged to capital or income. See that the receipts are taken for disbursements.

6. Review the need of an accounting, such as an intermediate account, with the attorney of the estate.

7. Make the necessary comparison of distributions made to see that they are in accord with the will or deed.

8. Prepare the various schedules of the account in accordance with the practice of the Surrogate's or other Court of the locality wherein the account is to be filed.

9. See that profits and losses are correctly used when filing annual tax or fiduciary returns. Also that changes of values of assets that would affect the inheritance tax return are reported to the lawyer before he makes a final settlement.

10. Where commissions are to be paid on an annual or other basis on capital and income, check that they are properly calculated.

11. Check to see that the investments are of the type authorized either by the will or deed or by the law, and report to the fiduciary thereon.

In short, make a careful audit of the executor or trustee's accounts periodically in conjunction with the counsel, and urge accountings be prepared as often as deemed wise—but not less than every five years.

Questions Regarding Estates and Trusts to Be Considered by the Lawyer vs. Those for the Accountant

By Mrs. Ellen L. Eastman, C.P.A.

Mr. Chairman, Members of the Committee and Members of the Society: The title of this paper is long and somewhat general; but, like many another title, its purpose has been served when it has been printed on the program. Do not let this title convey the thought that there is a conflict between the two professions, but rather that each recognizes his dependence upon the other.

Let us understand at the beginning that this paper does not attempt to instruct in the law and the procedure thereunder by which a fiduciary administers his trust. It is not appropriate that an accountant instruct in law, were he able, and it has been said that it is illegal to do so. Neither does it purport to instruct in the translation into figures of the administrative acts of a fiduciary.

The purpose of this paper is to try to distinguish between the functions of lawyers and accountants in fiduciary work, and to point out some of the danger spots which may be troublesome. The approach to the discussion is from the viewpoint of the accountant. The average lawyer recognizes the danger spots and he is warned that he needs the help of an accountant when he finds that schedules will not give the correct results and his account does not prove.

Some of the divisions of work are clear-cut and can be defined in unquestionable terms. There is a part of fiduciary administration which,

beyond any reasonable doubt, is accounting work and is generally performed by accountants. There are other parts of the administration which are legal work and there is no doubt but that this work must be done by lawyers. After this division, there is something left over which, with Robert Browning, we may call a "tertium quid". This "third something" does not lend itself easily to definition.

The cooperation of the lawyer and the accountant in fiduciary work is of greater importance than in any other branch of accounting. The need for lawyers to engage accountants to perform a large part of the work of estates and trusts has been recognized by the court in Matter of Bloomingdale, reported in 172 Misc. 218, where Surrogate Foley said, at page 225:

"An additional claim was made for $3,000 for the fees of accountants who assisted in the legal work. These services, however, were rendered by assistants included in the regular office staff of the firm of attorneys. * * * Such items are really part of the overhead of a modern law office. Consideration of them has been given by me in the fixation of the compensation of this firm of attorneys as above allowed."

The assembling, classifying and recording of all fiscal material is unquestionably within the field of the accountant. The work of advising the fiduciary as to his rights and duties and representing him in all matters in court are within the field of the lawyer.

A simple definition of the functions of the two professions may be stated as follows:

The lawyer interprets the law and its application, and the accountant expresses this interpretation in the language of figures. The lawyer defines the results to be obtained; the accountant arranges the facts to produce the results and then states them in figures. This does not mean that the accountant needs no knowledge of the law; he needs to have a very well grounded education in the laws affecting all phases of fiduciary work. He should be able to proceed under general advice of a lawyer, except in those cases in which the language of the instrument or the statute under which he is operating requires interpretation. In this field the court of last resort is the law and not our old familiar standard "generally accepted good accounting principles". Although the principles of accounting have great weight and are controlling where the law is silent, in many instances the law has fixed an arbitrary standard with which many accountants as a matter of first impression might disagree. Nevertheless, the accountant is bound by the legal standard. On the other hand, the accountant need not be tied continuously to the apron strings of the lawyer. Except where some general legal principle affects the situation or where the language of the instrument or the statute under which he is operating requires interpretation, the accountant should be able to proceed "under his own steam". The dividing line is not easily defined, and there is always the "tertium quid" to confuse the attempt to define. Each problem needs to be considered separately.

Before discussing the problems which may arise in exploring this "left-over something", let us first consider the type of work performed by both lawyers and accountants and the divisions in this work which are natural and obvious.

The questions which we are to consider tonight relate to estates and trusts; but guardianships of infants and incompetents often present the same problems.

A trust may be testamentary, that is, arising from or established under a will, or it may be inter vivos, that

is, created under a deed of trust, an agreement or other indenture. Sometimes, but now less frequently than formerly, wills create legal life estates; in which event the life beneficiaries have in certain respects a status similar to that of trustees, and are controlled by the rules governing trusts. If a will provides that the life beneficiary take the estate assets for his life and that upon his death they may be turned over to the remainderman, a legal life estate is created and it presents, with respect to income producing property, many problems similar to those arising in trusts. The legal life tenant is entitled to the income earned during his life, just as the equitable life tenant of a trust.

The kinds of work which accountants are well qualified and ordinarily called upon to do for fiduciaries are as follows:

The installation and supervision of accounting records.

The preparation of schedules for State and Federal estate tax returns.

The preparation of Federal gift tax returns.

The preparation of income tax returns.

The preparation of schedules for accountings.

We will consider briefly some of the things involved in the above enumerated classifications.

In regard to the records, there is no question but that the accountant is qualified to set up a system of accounting for the fiduciary with proper classifications of accounts to meet the requirements for all purposes for which the fiduciary needs to use his records. The supervision of the current work on these records is also undoubtedly work for an accountant, as is the preparation of statements of various kinds, proposed distribution schedules and estimates of income and expense. Needless to say, the lawyer in charge of the matter is consulted to determine the requirements of the fiduciary and to understand special uses to be made of the records.

The preparation of schedules for estate tax returns involves both accounting and legal procedure, and no line can be drawn separating one from the other.

In each of the other classifications of work, questions may arise in which it is important that the accountants have the advice of counsel before proceeding.

Some examples of the problems arising may clarify this statement.

Amortization

The question of transfer to principal for amortization of premiums on bonds purchased is a problem which can give much trouble. There are many parts to the question, and the transfer may be treated in one manner for accounting of the fiduciary and in another manner for income tax purposes. Whether or not amortization is to be taken and, if so, what method is required, is one which should be determined by the lawyer.

The treatment of amortization and the acts of the fiduciary generally, are subject to review by the court. The courts having jurisdiction over fiduciaries are courts of equity and not courts of law. Consequently, in reaching determinations, they give greater weight to what they consider fair and just under the circumstances of a particular case than to hard and fast rules of law. Generally speaking, accounting practices must follow fixed rules and consequently are more akin to law than they are to equity. Care must be taken in cases where equity may cut across the rules of law, because strict application of such rules would work an undue hardship. In such cases the advice of the lawyer may be necessary as to whether or not the usual

accounting practice should be followed or modified.

For example, a trustee may be required to amortize the premium on bonds purchased by him; but there are some instances in which the lawyer may decide to treat amortization differently. If a bond, the premium of which has been partially amortized, is sold at a profit above the remaining cost, there is the question as to the equity of making the income beneficiaries lose that part of the income deducted for amortization. The theory of amortization is to transfer to principal a part of the income collected in order to protect the principal fund and prevent depletion of it. If there is a profit on sale, an obvious question immediately arises. At this point the lawyer decides whether or not any part or all of the amortization previously transferred should be returned to income. Sometimes such a decision has to be made subject to approval by the court, which may or may not adopt the procedure followed.

Another question arises when bonds purchased by an executor at a premium are delivered to the trustee of a trust established under a will. Should the trustee amortize the premium on these bonds purchased by the executor and, if so, from what date is the computation of the amount of periodic transfers made?

Stock Dividends

A will or indenture of trust frequently provides for the treatment of stock dividends in respect to their credit or distribution to principal or income beneficiaries. The lawyer must determine the legality of this provision and the rule by which it is to be applied. The result is computed by the accountant and properly entered in the record or the accounts affected by it. If there is no such provision in the will or agreement, the law governs the allocation. Many cases on this question have been decided, and it is the lawyer's job to determine how these stock dividends are to be treated under the rules which, in his opinion, are applicable.

In regard to dividends on preferred stock accumulated and unpaid on the date of death in an estate or the date of the establishment of a trust, the accountant again may need a legal opinion. If these dividends are declared and paid after the dates mentioned, the question of the right of principal or income to receive them is an important one requiring interpretation, and it is a question of law and not of fact. The effect upon principal, if the allocation is to income, should also be determined by the lawyer.

Commissions

If the instrument under which a fiduciary is acting does not define the commissions of the fiduciary in respect to receiving and paying principal or income or both, the statute controls. It is the accountant's job to determine whether or not commissions have been taken on the correct basis, at the correct rates, and have been accurately computed. He should know, for example, that principal commissions are not paid on receiving and paying specific bequests in estate accountings, and that the so-called "annual rest" may be used for computing receiving and paying income commissions in trusts. Knowing these items of law, it appears at first thought that there are few problems regarding commissions. There are, however, many problems.

For example, if one of two cotrustees dies before the termination of his trusteeship, what commission is his executor or administrator entitled to receive for his services before death? In this case there are decisions which appear to conflict,

and courts have made allowances for commissions which appear to be contrary to a layman's reading of the statute. It is, therefore, of the greatest importance that this question be answered by the lawyer.

A similar question arises, but with a few added complications, if the trustee of a trust dies before the death of the life beneficiary. These complications may be enhanced by situations in which the trustee is the life beneficiary as well. The theory of computing the amount of commission to which the estate of the deceased trustee or executor is entitled is a question for the lawyer to determine. Once the theory is determined the accountant can prepare the schedules setting forth the facts and showing the results.

Real Estate

It often happens that while an executor may not be charged with real estate as a part of the estate, he acquires an interest in real estate through foreclosure of mortgages held by the decedent on the date of death or in the process of foreclosure on that date.

There are many questions arising in regard to real estate, one of which is the allocation of the proceeds of sale of real property between principal and income. This question is to be discussed by Mr. Allen and I will say only this: with the theory of apportionment decided, the solution of the problem is chiefly one of accounting. The accountant should not, however, be too self-confident in the matter of real estate allocation, for troublesome questions can arise in the application of the rule.

The assets of a trust often include real estate, and provisions for management and operation may be included in the trust indenture. These provisions may or may not be valid, therefore it is necessary, before proceeding with a trust account involving real estate, to obtain the advice of a lawyer in regard to all phases of its operation and sale. For example, if the trust indenture provides that future income from property be used to pay off a mortgage existing on the date of the establishment of the trust, this part of the agreement may be void. If provisions are made in the will or the trust indenture which are contrary to the statute, an opinion must always be had.

If the real estate is unimproved and there is no income from the property, carrying charges must nevertheless be paid. These may be paid from principal or from income cash, and it is for the lawyer to decide from which source he believes the payment should be made.

The foregoing examples relate chiefly to accountings. It may be helpful to point out some of the problems arising in the preparation of schedules for State and Federal estate tax returns. The valuation of the stock in a closed corporation as of the date of death in an estate, involves opinion as well as fact. The schedules setting forth facts are accounting work, and the conclusion as to valuation to be drawn from these facts can be made by anyone who has a thorough understanding of financial statements. It is, therefore, more intelligent for the accountant to draw these conclusions than for the lawyer to attempt it. However, in relating these conclusions to facts which cannot be expressed in figures—such as economic trends in the industry and pending legislation which may affect the value of the assets—the assistance of a lawyer and perhaps an economist can be helpful.

The valuation of insurance, particularly annuity contracts, offers many troublesome problems. The taxability or non-taxability depends upon the individual contract and the decisions of the courts in re-

spect to these or similar assets. It is, therefore, obvious that upon the lawyer in charge rests the burden of determining the taxability or non-taxability of the proceeds of insurance or annuity contracts for estate tax purposes. The computation of the taxable portion can then give the accountant sufficient difficulty.

There are many other examples which might be presented to illustrate the difficulty of drawing a clear line between the duties of a lawyer and those of the accountant. However, the foregoing are typical of the problems arising and the dangers confronting the accountant.

When the ice is thin, let the lawyer do the skating.

Investment Trusts

THE following addresses were presented at a special technical meeting on the evening of April 23, 1941, at the Engineering Auditorium, New York City, under the direction of the Technical Committee on Investment Trusts, of which George E. Niven is Chairman.

The Accountant and the Investment Company Act of 1940

By JESSE F. KAUFMANN, C.P.A.

In opening this meeting on "Investment Trust Accounting", and by way of introducing the subjects which will be discussed at greater length by the gentlemen who follow me, the Chairman of our Committee has asked me to tell you briefly something of the background of the Investment Company Act of 1940, with particular reference to its accounting aspects.

You are all familiar, of course, with the Securities Act of 1933 which for the first time in the history of our country, provided for the regulation of securities by a Federal authority. The passage of this Act represented only the first step in the plan of securities regulation, and it was followed quickly by the Securities Exchange Act of 1934 the primary purpose of which was to extend Federal regulation to cover the activities of securities markets. The former law was intended principally to govern the initial or original issue and sale of securities, while the latter provides for their permanent supervision as long as they are offered for sale on a national basis or traded in on a national securities market.

Going further, these two statutes were followed in 1935 by the Public Utility Holding Company Act and while this piece of legislation, as its name implies, concerned itself primarily with public utility holding companies, Congress nevertheless, in its enactment, gave passing attention to investment trusts and investment companies, and in Section 30 of this law we find the following provision:

"The Commission is authorized and directed to make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937".

This law, you will note, was enacted in August, 1935, and provided for the completion of the investigation of investment trusts and the presentation of a report thereon by January, 1937. The study was undertaken quickly; your Committee was requested, in January, 1936 (an excellent season of the year to find time for such an undertaking), to cooperate with the Securities and Exchange Commission in the preparation of a questionnaire to be filed by all affected investment trusts, and we spent considerable time in New York and Washington in that endeavor. The resulting questionnaire, when filed by all investment trusts, was used as the basis for the study and, after weeks and months of hearings before the Commission, its report was finally rendered under date of June 10, 1938

and several supplemental reports were submitted thereafter, the last of which was received by Congress in October, 1939. With these reports as a basis, the first bill providing specifically for the regulation of investment trusts was introduced before Congress in March, 1940, and, after protracted hearings, the bill which we now know as the Investment Company Act of 1940 was passed by Congress on August 13, 1940, and signed by the President on August 22, 1940—five years after the subject first was mentioned in an act of Congress.

So much for legislative history. The Act is divided into two titles: Title I, known as the "Investment Company Act of 1940", and Title II, known as the "Investment Advisers Act of 1940". The latter title, as its name implies, has reference to investment advisers, and has for its purpose, principally, the protection of the public from unscrupulous high-pressure security salesmen; this section of the Act has no direct relation to our endeavors, and need not concern us this evening.

The investigation of investment companies brought to light numerous abuses and disclosed many past evils in the industry which resulted in substantial losses to investors; the principal purpose of Title I of the Act, therefore, was to eliminate these practices and to prevent their recurrence. To bring about this desired end, the Act not only provides for the full and fair disclosure of information regarding investment companies and their securities, but also—and in this respect the Investment Company Act of 1940 differs materially from the Securities Act of 1933—provides for the regulation of their activities. To accomplish these purposes, the Act requires investment companies to register with the Commission by filing a notification of registration and, subsequently, a formal registration containing complete information regarding the registrant and its securities.

The Act, with certain exceptions, became effective on November 1, 1940, and applies to all investment companies, a term which, by definition in the law, is intended to be all-inclusive and covers all companies which are engaged primarily in the business of investing, reinvesting, or trading in securities, or companies engaging in such activities to the extent that more than 40% of the value of their assets are invested in securities; also included are companies which issue so-called "face amount" instalment certificates, or have such certificates outstanding.

The provisions of Title I of the Act, in so far as they relate to accounting matters, are considerably more specific and precise than are those of the preceding acts of Congress relating to securities. In the first instance, the law provides for the filing of annual reports with the Commission in form similar to those filed under the Securities Exchange Act of 1934 and, in addition, the companies are also required to transmit to their stockholders, at least semi-annually, financial statements containing not only the usual balance sheet and statement of surplus and profit and loss, but also a list showing the amounts and values of securities owned on the date of such balance sheet, and a statement of the aggregate dollar amount of security purchases and sales during the period. These reports to security holders must also show the aggregate remuneration paid by the company to all directors, officers, members of advisory boards, etc.

Of particular interest to our profession is the fact that these reports must be accompanied by a certificate of independent public accountants, based on an audit not less in scope or procedures followed than

that which accountants would ordinarily make for the purpose of presenting comprehensive and dependable financial statements. Such reports or certificates must also contain such information as the Commission prescribes as to the nature and scope of the audit and the findings and opinion of the accountant. Further, each such report must state specifically that the accountant has verified securities owned either by actual examination or by receipt of a certificate from the custodian. Through release No. 40, the Commission has directed that these reports must be issued to stockholders within thirty days of the balance sheet date.

Section 31 of the law provides that investment companies shall maintain and preserve such accounts, books, and other documents which may constitute the basis for the financial statements required by the Commission, and the latter is empowered to issue regulations providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by the companies. These regulations have not been issued as yet but it is interesting to note that the law itself makes some mention of accounting principles in the section relating to dividend payments. Such payments, says the law in effect, should be made from accumulated undistributed net income, determined in accordance with good accounting practice, and such net income shall not include profits or losses on sales of securities or other properties. Dividends may be paid from profits on sales of securities or from other sources but, in that event, the payment must be accompanied by a written statement which adequately discloses the source or sources of the distribution.

This section of the law has been the cause of some confusion among investment companies, because it has not been easy in many cases to determine the status of surplus in the manner required by the Act, for the purpose of ascertaining the source of dividend payments.

In further explanation of the statement to be made to stockholders when paying dividends out of sources other than accumulated undistributed net income, the Commission has issued a release — No. 71 — which, among other things, specifies that accumulated undistributed net income and accumulated undistributed net profits from sales of securities shall be determined, at the option of the company, either (1) from the date of organization, (2) from the date of a reorganization, if any, or (3) from January 1, 1925, to the close of the period as of which the dividend is paid. This release, however, still left considerable doubt in the minds of investment company managements concerning availability of surplus for dividends, and an interpretative bulletin has been issued by the Commission in connection therewith. Despite all this, however, it remains a fact that many problems will be encountered by investment companies in their attempts to ascertain the true character of surplus found on their books at the present day for the purpose of making the statement required by the Act.

Section 32 of the law provides for the selection and appointment of independent public accountants and requires, in effect, that such accountants must be appointed at the beginning of the company's year by a majority of the board of directors following which such selection must be submitted for ratification or rejection at the next succeeding annual meeting of stockholders. The employment of accountants must be "conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose

to terminate such employment forthwith without any penalty". It is further provided in this section that the certificate or report of the accountants shall be addressed both to the board of directors of the company and to the security holders thereof.

This same section provides, also, that the Commission may, by appropriate rules and regulations, require accountants and auditors to keep reports, work sheets and other documents and papers relating to investment companies for such period or periods as the Commission may prescribe, and to make the same available for inspection by the Commission.

Section 34 is the final section dealing specifically with accounting matters, and it relates to the mutilation or alteration of books, records, etc., and to the preparation or filing of untrue or misleading statements; all of which, of course, are unlawful.

These, in brief, are the matters of chief concern for the accountant in his work on investment companies. It had been the hope and expectation of this Committee to tell you more about the annual reports which must be filed with the SEC by investment companies under Section 30 of the Act; however, the regulations concerning these reports have not been released by the Commission as yet and we are all "in the dark" concerning them. In view of the time consumed to date in preparing these regulations, it would probably be the wiser course to expect the worst when they arrive.

Taxes of an Investment Company

By MARSHALL M. THOMAS, C.P.A.

With the demands of national defense calling for more and more revenue, one of the most important problems with which investment trusts will be faced in the immediate future is that of taxes. It is therefore intended to outline in a brief manner the taxes applicable to investment trusts, generally and specifically.

Purposely left out of the discussion are real and personal property taxes; organization, original issuance and filing taxes; Federal old-age benefit, and Federal and State unemployment taxes. These taxes are relatively unimportant from the viewpoint of most investment trusts, except in the cases of those trusts holding large parcels of real estate. Further, the subject has been confined to Federal, New York, New Jersey and Massachusetts taxes, since it appears that the majority in number and probably in excess of 75% of the total assets of investment trusts are located either in, or transact business in, the States of New York, New Jersey and Massachusetts.

Taxes to which investment trusts are subject may be divided into two main groups:

I. Taxes applicable to all corporations generally, including investment trusts.

II. Taxes applicable more or less specifically to investment trusts.

Under Section I are the following taxes:

1. Federal Income Tax, particularly with reference to taxation of dividends, interest and capital gains and losses.
2. Federal Excess Profits Tax.
3. Federal Capital Stock Tax.
4. Federal Declared Value Excess-Profits Tax.
5. New Jersey Franchise Tax—Domestic Corporations.
6. Massachusetts Excise Tax—Foreign Corporations.

Under Section II (taxes applicable more or less specifically to investment trusts) we find the following taxes:

7. Federal Tax on Mutual Investment Companies.
8. Federal Surtax on Personal Holding Companies.
9. Federal Surtax on Improper Accumulation of Surplus.
10. Federal, New York and Massachusetts Transfer Taxes.
11. New York Franchise Tax—Investment Trusts.
12. New York City Franchise Tax.
13. New Jersey Foreign Corporation Franchise Tax.
14. Massachusetts Excise Tax—Domestic Corporations.

Federal Income Tax:

The great bulk of investment trust income arises from dividends, interest, and profits on sales of securities. These items are all taxable under the Federal Corporation Income Tax statute. Interest, except tax exempt interest on Governmental securities, is taxable in its entirety; while only 15% of the dividend income is included. Capital gains and losses for tax purposes are divided into two categories: Short-term capital gains and losses—that is, securities held not more than eighteen months—and long-term capital gains and losses—securities held for more than eighteen months.

The matter of deductions need not be discussed here, as most of you are quite familiar with the fact that all usual business expenses and losses may be deducted. Mutual investment companies which prove to the satisfaction of the Commissioner that they are entitled to that status, are taxable in a separate classification, and these will be discussed in more detail later.

Federal Excess Profits Tax:

All investment trusts having excess profits net income of more than $5,000 are required to file excess profits tax returns; but mutual investment companies, which will be discussed later, and investment companies qualifying under the Investment Company Act of 1940 and registered as diversified companies before July 1, 1941, are exempt from the excess profits tax. Since long-term capital gains and dividends are not subject to tax for excess profits tax purposes, many investment trusts find they are not subject to excess profits tax. However, those companies which have substantial income from taxable interest will find the excess profits tax applicable if the inclusion of such interest causes them to have an excess profits net income of more than $5,000. Such companies may find a considerable advantage in registering as a diversified company under the Investment Company Act of 1940. A diversified company is defined as "a management company which meets the following requirements: at least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities, for the purposes of this calculation limiting in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer".

While the Investment Company Act subjects these companies to considerable regulation, this factor is somewhat offset by the exemption from excess profits tax. It is clear why Congress exempted from excess profits taxes a mutual investment company, inasmuch as such a company must declare in dividends 90%

of its net income; but no such requirement prevails in the case of a registered diversified investment company.

While the rates under the present act run from 25% on the first $20,000 of adjusted excess profits net income to 50% of such adjusted excess profits net income in excess of $500,000, an increase in rates running from perhaps 25% on the first $10,000 of adjusted excess profits net income to a maximum rate of 75% is a distinct and live probability. However, to repeat, for those companies in which dividends and capital gains constitute the entire gross income, the question of excess profits tax is academic and, only in the event that dividends and capital gains are taxed in the 1941 act, will the problem be acute. Investment companies, like commercial corporations, are of course subject to the Federal capital stock tax and the Federal declared value excess profits tax.

New Jersey Franchise Tax—Domestic Corporations:

For investment trusts incorporated under the laws of the State of New Jersey, the franchise tax is based on the total issued and outstanding capital stock including treasury stock as of January first of the taxable year, and the rates are on sliding scales, based on capitalization.

Massachusetts Excise Tax—Foreign Corporations:

Foreign investment trusts in the State of Massachusetts are taxable the same as foreign manufacturing business corporations, although there is a separate tax on domestic trusts in the State of Massachusetts.

* * *

That concludes the list of general taxes applicable, and we now come to the list of taxes which apply in substantial degree almost solely to investment trusts:

Federal Tax on Mutual Investment Companies:

As stated above, mutual investment companies are exempt from the Federal excess profits tax, but are subject to a special normal tax of 24% based on what is defined as "Supplement Q" net income. A mutual investment company is any domestic corporation, other than a personal holding company, if:

(a) It is organized for the purpose of and substantially all of its business consists of holdings invested or reinvested in stock or securities.

(b) At least 95% of its gross income is derived from dividends, interests and gains from sale or other disposition of stock and securities.

(c) Less than 30% of its gross income is derived from the sale or other disposition of stock or securities held for less than six months.

(d) An amount not less than 90% of its net income is distributed to its shareholders as taxable dividends during the taxable year; and:

(e) Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interest in the company's property or the cash equivalent thereof less a discount not exceeding 3%.

The tax of 24% applies whether or not the net income is above or below $25,000. Supplement Q net income is the adjusted net income less partially taxable United States bond interest, and without deduction for the net operating loss carryover, and minus the amount of dividends actually paid and/or the consent dividends credit. A mutual investment company thus is more or less analogous to a personal holding company which must pay out its income or suffer a confiscatory tax.

It is also comparable to a registered diversified company under the Investment Company Act of 1940 in that it will not be deemed to be a mutual investment company if more than 5% of the gross assets of the company are invested in the securities of any one corporation or if it owns more than 10% of the outstanding securities of any one corporation. As stated heretofore, a mutual investment company is entirely exempt from excess profits taxes.

Federal, New York and Massachusetts Transfer Taxes:

Since the purchase and sale of securities is a relatively important function of most investment trusts, the question of transfer taxes becomes important. The present Federal rate on the transfer of stocks is 5¢ per $100 of face value for stocks selling at $20 or under, and 6¢ for those selling over $20. On no-par-value shares, the rate is 5¢ for stocks selling at $20 per share and 6¢ for those selling over $20. Corporations effecting transfers of taxes in New York and Massachusetts are subject to similar taxes by those States, the New York rate being 3¢ per share for sales at $20 or under, and 4¢ per share for sales in excess of $20 per share. The Massachusetts rate for transactions effected in that State is 2¢ per $100 on par value shares, and 2¢ for each no-par-value share.

The stock transfer tax is exacted upon the transfer of legal title, and is not a tax on the certificates of stock. Legal title is to be distinguished from real or actual title, and there can be a transfer tax on certain transactions where the actual or real ownership is undisturbed; as, for instance, "the transfer of stock to or by trustees", or "the transfer of stock from parties occupying fiduciary relations to those for whom they hold stock". The transfer tax is also applicable to transactions such as:

(1) The transfer of the right to subscribe for stock.

(2) The transfer of the right to receive stock which a corporation has unconditionally agreed to issue.

In New York there is no tax upon a transfer of certificates under a non-corporate investment trust agreement of the fixed type, but a similar transfer of certificates of a management type trust would be taxable.

New York Franchise Tax—Investment Trusts:

The State of New York in recent years, in order to stem the tide of investment trusts moving to the State of New Jersey, has relaxed its franchise tax requirements, and both domestic and foreign investment trusts operating in the State of New York pay a tax calculated on a method which produces the highest tax of the following three:

(1) Apportioned entire net income at 4½%.

(2) Apportioned capital stock at 1 mill per dollar.

(3) And a minimum tax of $25.

Since the rate on ordinary domestic and foreign corporations is 6%, it is clear that the 4½% is a concession to investment trusts. Where the apportionment of capital stock would be applicable as a method of taxing, both domestic and foreign corporations have the further advantage of segregating their security holdings on the basis of the segregation of underlying companies.

An investment trust is defined under the New York franchise tax act as a corporation principally holding, investing in and reinvesting in securities for its own account provided 85% of its gross assets at cost consist of securities and cash and not over 20% of such assets in one cor-

poration (except of an investment trust or municipal corporation).

New York City Gross Receipts Tax:

In the city of New York, financial businesses, including investment trusts, are taxed at 1/5 of 1% of the gross income regardless of the amount, there being no exemption of $10,000 for investment trusts as there is for commercial businesses. The gross income means gross receipts, including profits on sales of securities.

New Jersey Foreign Corporation Franchise Tax:

New Jersey, in vying with the State of New York, also makes a large concession to investment trusts. Any foreign corporation whose assets located in New Jersey consist of bonds, stocks, mortgages, or other evidences of indebtedness and intangible personal property, and whose principal business consists of purchasing and selling securities and the receipt of interest, dividends and income from such securities or other intangible property, is exempt from the foreign corporation franchise tax. Investment trust corporatons, to claim this exemption, must annually file, on or before August 15, a report showing that 90% or more of assets located in New Jersey are securities as mentioned above. The fee for filing the report is $25. This, of course, means that any foreign investment trust whose securities are held in safe deposit boxes or in custodianship in the State of New Jersey would have nothing but a minimum tax of $25 to pay.

Massachusetts Excise Tax— Domestic Corporations:

Massachusetts corporations dealing exclusively in securities pay an excise tax calculated as follows: 6% on taxable interest and dividends, 1½% on business income, and 3% on gains from sales of intangibles, less 6% of the dividends paid by such corporation during the year in which such income was received.

* * * *

The discussion up to this point has been confined entirely to incorporated investment trusts. There are, throughout the country, certain organizations unincorporated, owned by holders of beneficial interest certificates, which may or may not be classified for tax purposes as corporations. Up to about eight years ago, it could be said that there were a considerable number of organizations in this classification. Prior to that time, these organizations were deemed to be not taxable as entities, the incidence of the tax falling on the constituent certificate holders. However, during the past few years, based on court construction and strict enforcement by the Internal Revenue Bureau, there are few, if any, representative investment trusts not taxable as entities. If the trustees act as officers and the certificate holders exert any control whatsoever, and the organization is run *as a business,* it is fairly safe to make the assertion that such organization will be taxed as a corporation and therefore will be subject to the taxes heretofore discussed. In those cases, however, where, by ruling of the Internal Revenue Bureau, the investment trust organization has been deemed not to be an association taxable as a corporation, the above mentioned taxes, of course, are not applicable, and the distributions made to the individual certificate holders will be taxed to them as part of their individual income tax; in which case, the distributions will have to be broken down into the constituent elements of income for filing the individual tax returns.

The subject of taxes on investment trusts is so broad that, in a discussion of this kind, it is not practicable to discuss any given tax exhaustively.

Accounting Principles and Auditing Procedure

By Thomas J. Cogan, C.P.A.

There are possibly two points where the salient features of investment company accounting differ somewhat in relative importance from those of other fields.

The first is the fact that, while in commercial organzations, accountants have, in general, given to the income statement the place of primary importance, in investment companies that place is still held by the balance sheet, from which the investor may determine the asset value of his stock (i.e., the amount of net assets of the company, with investments taken at market valuations, applicable to each share of outstanding stock).

Present thought has tended to regard accounting as primarily a "matching of costs against the revenues of an enterprise" and the income statement is considered as the portrayal of the results of this effort. However, in an investment company, the income statement is not as conclusive, as it is in other cases, as an indication of performance. The amount of income from dividends probably depends more on the investment policy chosen by a company than on managerial ability. Likewise, security profits realized, reflect a number of factors in addition to investing perspicacity; for example, the time when a company was organized and acquired the bulk of its investments—and tax considerations. Consequently, the most significant measuring stick of relative performance of investment companies in most cases appears to be afforded by a comparison of changes in per share asset values reflected in balance sheets. The company which has had an increase of, say, 10% in its per-share asset value, probably will be deemed to have shown better performance than one which has had a decrease of 10%, even though the second company may have shown larger income and more realized security profit during the period.

The second point, which has become especially important with the passage of the Investment Company Act of 1940, is the effect on investment company transactions of Governmental regulations. The auditor of an investment company will probably have, now, a certain responsibility to ascertain whether or not transactions subject to his review comply with the various provisions laid down by that Act and with rules of the Securities and Exchange Commission under the Act. These are quite numerous, and there may be, in the beginning at least, a number of inadvertent infractions. The auditor's examination of accounting records places him in a position to bring such infractions to the client's attention.

Since the general subject of accounting principles and auditing procedures is a very broad one, even when confined to such principles and procedures as apply to investment companies, any comprehensive discussion would require much more time than can be allotted to it in a meeting of this nature.

The question of how detailed an audit must be in the case of an investment company is an important one. Generally, the volume and uniform flow of transactions and the degree of internal control which characterize a commercial organization and which make possible the examination of a representative portion of transactions as a means of arriving at a conclusion concerning all transactions is not present in an investment company. It is usually considered necessary to make

a detailed examination of transactions in order to be in a position to render an unqualified opinion with respect to the company's financial statements. However, the fact that a detailed audit is made should not cause the auditor to forget his responsibility to see that the company's system of internal control is as effective as possible.

Probably the easiest way to take up the subject of this paper is to center the discussion around some of the items which appear in financial statements of investment companies—rather than attempting a review of all pertinent matters. Certain items—cash and prepayments for example—need not be discussed, since their treatment is no different in the case of an investment company than in any other case.

The first item which comes to mind in the case of an investment company is its most important asset, the company's security investments. Here, as in other cases, the auditor has two problems: verification that an asset represented on the balance sheet is actually owned, and assurance that it is portrayed in accordance with accepted accounting principles. The first step to establishing ownership is to see that the securities have been bought and paid for; this involves examination of brokers' bills and cash transactions. The second is to ascertain that, having been acquired, the securities are on hand on the balance sheet date. If the company keeps its securities in its own vaults, this involves a count of bonds and stock certificates. If they are held by a custodian, a confirmation is customarily secured from the custodian. Some State securities commissions have felt that auditors should make a physical count even when securities are held by a custodian, and the Securities and Exchange Commission has issued a rule, under the Investment Company Act of 1940, requiring such counts in cases where the custodian is a broker. Auditors probably will not object to doing this additional work. However, it seems that unless the securities counted are registered in the name of the investment company rather than in the name of the custodian or its nominee, as is usually the case, the substantiation afforded by inspection of certificates is not particularly conclusive in view of the opportunity of substitution. The auditor, in these cases, should endeavor to compare the numbers of certificates inspected with the numbers shown on the company's records and should, in any event, insist upon a confirmation from the custodian in addition to his count.

It has been suggested at times—and this applies to all security counts—that inspection of stock certificates affords no great assurance of ownership of the securities counted; that the auditor does not know whether or not certificates have been forged or if endorsements are valid. The truth of these suggestions is readily admitted. But, if an auditor sees evidence that a particular security has been purchased and then sees a certificate for that security, it seems to me that in the absence of unusual circumstances, he has reasonable grounds to believe that the company owns the security.

Having received assurance that the securities are actually owned, the auditor's next concern is the manner of their presentation in the company's financial statements. This problem involves, in most cases, determining if the cost at which they are shown has been determined in accordance with generally accepted accounting principles. Where no part of a particular security has been sold, cost is simply the aggregate of a series of purchase prices. But when part of an investment has been sold, a basis must be adopted for determining the portion of total

cost which is to be allotted to the sale. Three methods are in general —almost invariable—use:

(a) On the theory that one share of a particular stock is the same as any other, average per-share costs are used in determining cost of shares sold.

(b) The first lots purchased are assumed to be the first sold.

(c) The cost of the stock sold is considered to be the cost of the particular certificates which were delivered against the sale.

All of these methods are being followed and are accepted by accountants, though this statement should not be construed to mean that all are considered to be equally desirable. While it is outside the scope of this paper to discuss the relative merits of these three methods, it might be mentioned that the Securities and Exchange Commission has indicated some dislike for the identified-certificate cost method and, when it is used in statements filed with it under the 1933 and 1934 Securities Acts, requires a footnote showing what profits and losses would be if computed on the basis of average costs.

Since practically all balance sheets of investment companies show both cost and market value of investments, some discussion of market values seems appropriate. In the first place, it has appeared to me that the use of the word "value" may be interpreted by some readers to have more significance than is intended by its users. I believe that all references to the phrase "market value" should include a definition that such value is merely the application of published market prices to the number of shares owned, and is not necessarily a representation of realizable value. In most cases, closing sale prices are used or, when there are no sales reported on the balance sheet date, closing bid prices; in some instances the average between the closing bid and asked price is used, rather than the closing bid. Except in unusual circumstances it is unlikely that choice of these methods would produce widely differing results.

Discussion of investments suggests consideration of the income derived from investments, namely dividends and interest. In his role of verifier, the auditor must see to it that all dividends and interest receivable during the period under review have been properly accounted for. The preferable way to accomplish this seems to be by reference to published sources of payments and comparison thereof with investment positions during the period.

With regard to accounting principles involved in accounting for income, most of the questions which arise probably can be put in two categories: (a) when receipts of dividends and interest are returns of capital rather than income, and (b) when stock dividends and rights are income and when they are not.

The rule as to when a dividend or interest item is income and when it is a return of capital seems to have been worked with practicality as the main consideration. Generally, regular dividend and interest payments, not specifically stated to be liquidating distributions, are treated as income and, under most circumstances, this appears to be proper. Some companies follow tax rulings in deciding whether dividends received are income or a return of capital. There usually is no objection to this basis of determination.

While some thoughts have been expressed to the effect that the recipient of a stock dividend receives income up to the value of the stock received, just as much as if he had received cash or other property, the majority of accountants regard the ordinary stock dividend—that is, a dividend paid to common stockholders in common stock of the paying company—as merely a prolifera-

tion of outstanding shares, rather than income. However, it is impracticable to discuss in a paper of this general nature, the various theories which have been advanced on this subject. Most investment companies include in income, stock dividends which are taxable income (such as payments in preferred stock), but exclude non-taxable stock dividends.

An important matter which arises in the audit of investment companies of the "open-end" type (those that issue and redeem shares at asset value) is the verification of transactions in capital shares. The charters of these companies usually provide —and their prospectuses set forth— that the company shall receive asset value for shares issued and will repurchase shares on demand (or within a short period of demand) at asset value. The auditor has the responsibility to see that this policy is actually being followed. Tests should be made of the actual computations of prices used in connection with the issuance and redemption of shares. Since there will ordinarily be a determination of asset values once a day, the auditor must, as a practical matter, rely on tests of the accuracy of the computation of such asset values. This makes it particularly important for him to be sure, in this instance, that the company's internal accounting procedures and system of internal check and control are reliable.

Among points to be observed in connection with the daily determinations of asset values are:

(a) Whether or not provision has been made for deduction of costs of realization such as brokerage commissions and transfer taxes, if such deductions are provided for in the company's charter.

(b) Whether or not proper provision has been made for the accrual of all taxes. Even though provided for on an estimated basis, the company's computation should recognize such items as Federal capital stock, State franchise taxes and Federal income taxes on realized and unrealized profits (if applicable).

(c) Whether or not other expenses are accrued—the items most generally present being management fees, transfer and custodian expenses, etc.

The ascertainment that proper liability for taxes has been provided is an important feature of an investment company audit—taxes are the largest liability item in some investment company balance sheets. Many investment companies classify themselves as "mutual investment companies", a class of company which, as has been stated, is accorded special treatment for Federal income tax purposes and in computing Delaware franchise tax. Exemption from Federal excess profits tax has also been granted to "mutual investment companies", as it has been to the "diversified investment company" class designated under the Investment Company Act of 1940. Since a company's tax liability will be materially affected if, considering itself to be a "mutual" or "diversified" company, it has in any way failed to conform to the requirements laid down by the statutes for such companies, it is an obvious duty of an auditor to see that all necessary requirements have been complied with or, failing such compliance, that the consequent additional tax liabilities are recognized in presenting financial statements.

Effect of Recent Securities and Exchange Commission Regulations on Financial Statements of Investment Companies

By HARRY I. PRANKARD, 2ND, C.P.A.

In its release No. 40 under the Investment Company Act of 1940, dated January 2, 1941, the Securities and Exchange Commission prescribed certain minimum information to be included in periodic reports to stockholders of investment companies and has given recognition to a distinction between the type of information that must be given by "open-end investment companies" and "closed-end investment companies."

An "open-end investment company" is defined by the Investment Company Act of 1940 as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."

A "closed-end investment company" is defined by the same Act as "any management company other than an 'open-end company' ".

A "management company" is defined by the Act as "any investment company other than a face-amount certificate company or a unit investment trust". Because of time limitations, this paper will be confined to a discussion of the financal statements of management companies.

The information to be included by a management investment company in its periodic reports to stockholders, which reports must be issued at least semi-annually, is the following, or its equivalent:

(1) A balance sheet accompanied by a statement of the aggregate value of investments at the date of such balance sheet.

(2) A list showing the amounts and values of securities owned on the date of such balance sheet.

(3) A statement of income, for the period covered by the report, which shall be itemized at least with respect to each category of income and expense representing more than 5% of total income or expense.

(4) A statement of surplus which shall be itemized at least with respect to each charge or credit to the surplus account which represents more than 5% of the total charges or credits during the period covered by the report.

(5) A statement of the aggregate remuneration paid by the company during the period covered by the report: to all directors and to all members of any advisory board for regular compensation; to each director and to each member of an advisory board for special compensation; to all officers; to each person of whom any officer or director of the company is an affiliated person.

(6) A statement of the aggregate dollar amounts of purchases and sales of investment securities, other than Government securities, made during the period covered by the report.

In its release of January 2, 1941, the Securities and Exchange Commission stated that an "open-end investment company" may include in its periodic reports as the equivalent of the balance sheet and the statement of surplus, the following:

(1) A statement of its assets, showing its investments at market value, its liabilities, its net assets, and the number and par or stated value of the shares representing such net assets.

(2) A statement of changes in net assets for the period for which the report is made, showing the net assets as at the beginning of the period, and the various credits and debits

resulting in the net assets at the end of the period.

(3) A statement with respect to the period for which the report is made, and with respect to the three complete fiscal years next preceding the commencement of such period, of the net asset value per share of the reporting company's securities at the beginning and at the end of each such period, and a statement of the dividends declared per share during each such period, together with the amount per share of such dividends declared out of sources other than net income for each such period, excluding from such net income profits or losses realized on the sale of securities or other property.

As many "open-end investment companies" have elected to include the statement of net assets and the statement of changes in net assets, together with certain historical information as to the net asset value per share of its stock and the amounts and sources of its dividends in its periodic reports, rather than the customary balance sheet and statements of surplus, I believe it will be of interest to the members of the Society if I discuss briefly how such statements differ from each other.

To assist me in my discussion I have prepared and furnished to each of the members present a set of financial statements in the same form as those included in the 1940 annual report of a well-known "open-end investment company". I believe these statements meet all the requirements of the Securities and Exchange Commission for periodic reports.

* * * The statements referred to appear on the following pages herewith.

STATEMENT OF NET ASSETS, DECEMBER 31, 1940

ASSETS

Securities, at market quotations (cost $31,000,000)	$25,000,000
Cash on demand deposit	1,000,000
Dividends receivable	100,000
Receivable for capital stock sold—(in process of delivery)	50,000
Total	$26,150,000

LIABILITIES

Accrued expenses and taxes (see note)	$ 20,000
Payable for capital stock reacquired—(not yet received)	30,000
Total	$ 50,000
NET ASSETS (based on carrying securities at market quotations)—equivalent to $10 per share for 2,610,000 shares of $1 par value capital stock outstanding at December 31, 1940	$26,100,000

NOTE: No Federal income tax has been accrued on the basis that the company qualified under Section 361 of the Internal Revenue Code during the year ended December 31, 1940, and distributed all of its net income during such year.

Securities Owned, December 31, 1940

Company	Shares	Market Value
Amerada Corporation	1,000	$ 46,375
American Can Company	2,000	177,000
Commonwealth Edison Co., Etc., etc.	4,300	126,313
Total		$25,000,000

STATEMENT OF INCOME
(Exclusive of Gains or Losses on Securities)
For the Year Ended December 31, 1940

Dividend Income		$1,700,000
EXPENSES:		
Compensation of officers, directors, and members of the advisory board (1/4 of 1% of the average of the liquidating values of the outstanding capital stock on each business day during the year)	$75,000	
Fees paid trust company:		
As custodian	25,000	
As transfer agent and for dividend disbursement	25,000	
Legal fees	10,000	
Auditors' fees	10,000	
Provision for Federal capital stock tax and other taxes	35,000	
Miscellaneous expenses	20,000	200,000
Net Income for Year (exclusive of gains or losses on securities)		$1,500,000

STATEMENT OF CHANGES IN NET ASSETS
For the Year Ended December 31, 1940

Net Assets, Dec. 31, 1939 (including undistributed net income $100,000)	$30,000,000
CREDIT:	
Net income for year (exclusive of gains or losses on securities)	1,500,000
CHARGES (*in italics*):	
Increase in unrealized depreciation of securities owned (less $20,000 net profit from sales of securities on basis of average cost)	(3,500,000)
Cost of capital stock reacquired ($3,000,000), less proceeds from sales of capital stock ($2,500,000)	(500,000)
Dividends paid to stockholders	(1,400,000)
Net Assets, Dec. 31, 1940 (including undistributed net income $200,000)	$26,100,000

( ) Denoted deduction.

SUPPLEMENTARY INFORMATION

Statement Showing Net Asset Value Per Share at the End of Each of the Last Five Years, Together with Amounts and Sources of Dividends Declared Per Share During Such Years

		Dividends Declared Per Share		
		Sources		
Year	Net Asset Value Per Share December 31st	Investment Income*	Capital Gains	Total
1936	$15.50	$.60	$1.00	$1.60
1937	9.00	.50	.14	.64
1938	10.50	.30	—	.30
1939	10.25	.40	—	.40
1940	10.00	.50	—	.50

* i.e., net income, excluding profits or losses from the sale of securities or other properties, adjusted for portions of net proceeds from sales and reacquisitions of capital stock required to equalize per-share undistributed net income at dates of sale or reacquisition.

Aggregate Dollar Amounts of Purchases and Sales of Investment Securities

Purchases and sales of investment securities during the year aggregated $1,700,000 and $2,000,000 respectively.

Compensation of Officers, Directors and Members of the Advisory Board

The aggregate regular compensation paid to all directors and to all members of the advisory board was $75,000, which includes the sum of $40,000 paid to the following officers: John Doe, Chairman of the Board; Thomas Doe, President; James Doe, Vice-President, and Harry Doe, Assistant Treasurer.

Compensation Paid to Persons or Concerns with Which Directors or Officers or Members of the Advisory Board Are Affiliated

The trust company, as Custodian, Transfer Agent and Dividend Disbursing Agent, received $50,000 for its services in 1940. Charles Doe is Chairman of the Board, and John Doe is a director of this bank.

John Brown & Co., security dealers, received $5,000 in 1940 as commissions for executing purchase and sale orders on stock exchanges for the account of the company. Thomas Doe is a member of this firm.

Brown & Smith received $10,000 as counsel for the company during 1940. James Doe is a member of this firm.

If you will examine these statements you will see that there is a statement of net assets at December 31, 1940, in lieu of the customary balance sheet. The presentation of the assets of the company is in the customary form, as is the presentation of the liabilities. The liabilities are deducted from the assets to arrive at the net assets of the company, and the number of shares and par value of capital stock outstanding on the balance sheet date, as well as the net asset value per share of outstanding capital stock, are shown parenthetically.

It will be noted that the principal deviation of this statement from the customary balance sheet is in the absence of information as to the composition of the net assets or net worth of the company. No detail is given as to the balances of capital stock account, paid-in surplus, earned surplus, etc.

It will be noted that the statement of income for the year is presented in the customary form except that gains or losses from sales of securities are not included. Such security gains or losses have come to be looked upon—not only by the majority of investment companies but also by the Securities and Exchange Commission and by the various State security commissions—as resulting from capital transactions, and it is now generally considered desirable to segregate such gains and losses.

The third statement reflects changes in net assets during the year. The dollar amount of net assets at the beginning of the year constitutes the first item on this statement. To this amount are added the net income for the year and any other items which would increase the net assets of the company and, from the resulting total, there are deducted the depreciation during the period in the market value of securities owned, the excess of the cost of capital stock reacquired over the proceeds from the sale of capital stock, and the amount of dividends paid to stockholders. The remainder represents the net assets of the company at the end of the year and, of course, agrees with the net assets determined by deducting the liabilities from the assets of the company.

The next statement (referred to as a "Statement of Supplementary Information") sets forth the remaining information required by the Securities and Exchange Commission to be disclosed in periodic reports to stockholders, as follows:

(1) A statement showing certain historical information as to the fluctuations in the net asset value per share of the investment company's capital stock, together with the per-share amounts and sources of dividends paid during the past several years.

(2) The dollar amount of purchases and sales by the company of its investment securities during the period covered by the report.

(3) The compensation paid during the period covered by the report to officers, directors, and members of the advisory board.

(4) The compensation paid during the period covered by the report

to persons or concerns with which directors, officers, or members of the advisory board are affiliated.

Since the information disclosed by these financial statements differs from the information ordinarily contained in financial statements, it may be of interest to the members of the Society if I discuss briefly the more important of these differences.

An important difference is the omission of the composition, as at the end of the year, of the various elements of net worth, such as capital stock, paid-in surplus, earned surplus, etc. This detail does not appear to have the same significance in an "open-end investment company" as it would have in a company where the amount of issued capital stock changes but infrequently. It is argued—and quite soundly so, in my judgment—that to show a surplus balance representing, for example, accumulated profit or loss from sales of securities, less the amount of such profits as have been paid out in the form of dividends, for a period of many years starting with the date of the commencement of business by the company, serves no useful purpose. Indeed, it is argued, the meaning of such a surplus balance might be misinterpreted.

If the balance sheet of one investment company which commenced business in the fall of 1928 disclosed at the end of 1940 a $5,000,000 deficit in its security profit and loss account, and the balance sheet of another investment company of substantially the same size (which, however, commenced business in the summer of 1932) disclosed a $1,000,000 surplus in its security profit and loss account, the reader of such statements might conclude that the latter trust had the more efficient management. If, however, the policy of both companies had been to keep a substantial portion of their funds invested, and one company raised most of its capital during the fall of 1928 when security prices were much higher than they were at the end of 1940, and the second investment company raised most of its capital during the summer of 1932 when security prices were much lower than they were at the end of 1940, it would not be reasonable to conclude that the management of the second investment company was more efficient than that of the first. For this and other reasons it is felt that a statement of the net asset value per share of the company's capital stock at the beginning and at the end of each fiscal year for at least three years, together with the amounts and sources of dividends declared during such periods, gives a better indication of the efficiency of management.

Another difference between these statements and the statements usually included in periodic reports is the absence of surplus accounts and the inclusion of a statement of changes in net assets in lieu thereof. Ordinarily, I think, it is probable that the information set forth in the statement of changes in net assets, which you have before you, would be set forth in four different surplus accounts.

First, there would be a statement of earned surplus exclusive of profits or losses from sales of securities.

Secondly, there might be a statement of security profits surplus, which would show the accumulated net profit or loss from sales of securities.

A third surplus account might include unrealized appreciation or depreciation in the market value of portfolio securities.

The fourth statement would be the paid-in surplus account. This account would include the excess over par value of the consideration received for capital stock sold, less the excess over par value of consideration

paid for capital stock reacquired.

It will be seen, therefore, that the only information contained in a complete set of surplus statements which is not revealed in the statement of changes in net assets, is the opening and closing balances of the surplus accounts, which balances are of questionable significance in a periodic report of an "open-end investment company".

On the other hand, the information required to be set forth supplemental to the financial statements, seems to me to be of real significance to the reader.

Contingent Liabilities and Commitments

AT a special technical meeting of the Committee on Contingent Liabilities and Commitments held on the evening of October 9, 1940, at the Engineering Auditorium, New York City, the following addresses were delivered under the direction of Francis Wm. Hopkins, Chairman. Following the presentation of the Committee's papers, a discussion was held on the various State unemployment insurance laws, the Federal and State labor law (wages and hours) and the Federal social security laws.

Contingent Liabilities and Commitments with Reference to the Securities and Exchange Commission

By FRANCIS WM. HOPKINS, C.P.A.

When I agreed to read a paper on "Contingent Liabilities and Commitments" with reference to the SEC, I did not know that there was so little material available, so therefore my talk tonight will be of necessity one of reference. By reason of the fact that I have made a rather exhaustive study you may be interested in making notes of my references.

Obviously, for any information in connection with the releases, rules, and regulations of the SEC with respect to contingent liabilities, one would write to the chief accountant of the Securities and Exchange Commission. I was very much surprised when I received a letter under date of July 19 from Mr. William W. Werntz, and you also will probably be surprised; it is not long—to wit:

"This will acknowledge receipt of your letter in which you inquire as to where you can obtain the Commission's rulings and decisions in respect to cases involving contingent liabilities and commitments.

"A copy of Regulations SX" is enclosed. The Commission's requirements as to the disclosure of contingent liabilities are set forth in Rule 3-18 (e) on page 8 of this Regulation. No accounting series releases or other rules and regulations dealing with this subject have been published; however, the Commission has commented on contingent liabilities in the following cases:"

(I won't read the cases now because I am going to discuss them briefly a little later).

My reading the Regulation SX, Rule 3-18 (e), will emphasize its brevity.

"Contingent Liabilities—a brief statement as to significant" (mark that word "significant") "contingent liabilities not reflected in the balance sheet shall be made. In the case of guarantees of securities of other issuers, a reference to appropriate schedule shall be included."

Now, that is rather a brief requirement. I asked you a moment ago to note the word "significant". That word "significant" might take on as many different meanings as there are people in this room, and that more forceably reminds us of the remarks of the previous speaker: "We have got to use our judgment."

I do not believe "significant" in this sense means anything that is an ordinary procedure in the business. As an example, consider any business that operates on the Produce Exchange—sugar, coffee, rubber. It is an established business principle and policy to buy and sell future contracts in those commodities and show the position as of a given balance sheet date. There is certainly

a profit or a loss in hedging or covering those contracts, but is that a matter that we should footnote on our balance sheet, or does it come under the heading of an ordinary business activity of the industry involved.

I have briefly outlined the decisions referred to by Mr. Werntz and for your own information, I will note where they may be found.

Decision 338 in the matter of Bering Straits Tin Mines, Inc., File #2-2837 and described on page 486 of Volume 2 of SEC Decisions and Reports: Possible liability of registrant to purchasers of its securities sold prior to effective registration-balance sheet held incomplete for failure to include contingent liability arising out of registrant's offer to permit previous purchasers of its securities to rescind their purchases and recover the purchase price thereof." The preceding is in connection with the filing of the registration statement, not the annual report for corporations.

The next case noted is found in Volume 2 of the SEC reports, page 548, in connection with Canusa Gold Mines, Ltd., File #2-2591: Failure to show possible liability from illegal sales of securities. "Where underwriter had sold and distributed stock in apparent violation of Securities Act of 1933, and where minutes of the board of directors showed that the corporation had full knowledge of such distribution by an underwriter, and where no exemption under Section 3 of the Securities Act appeared applicable, it was held that while the Commission would not adjudicate the question of civil liability provision of Sections 11 and 12 of the Securities Act of 1933, a possible contingent liability existed and that failure to disclose such contingent liability on a balance sheet and a statement that there were no contingent liabilities known, rendered the financial statements untrue."

A third case is found in the same volume, page 892 (and, incidentally, these volumes will be found in the American Institute's library)—the case of the Petersen Engine Company. Contingent liabilities—possible liability of registrant to purchasers of its securities sold prior to effective registration, "on facts presented, registrant held required to note on its balance sheet a possibility of liability, under Section 12(1), 12(2) and 15 of the Securities Act of 1933, to purchasers of its securities sold by registrant's distributor with the knowledge of registrant both prior to effective date of registration statement as amended and after the institution of stop order proceedings."

Our fourth case is found in Volume 3 of the SEC reports, page 153, in the matter of Crusader Air Craft Corporation. Untrue or misleading statements or omission—statements as to fund for unpredictable or unforeseen contingencies, "Registrant's disclosure that $215,000.00 is to be set up as a 'contingent fund' to be used" (this is rather a well known case and many of you may be familiar with it, but I believe it is worth repeating here) "for unpredictable or unforeseen contingencies —constituted a material misrepresentation, where registrant failed to take cognizance of a prior tax claim toward the payment of which a substantial portion of the anticipated proceeds from the sale of registrant's stocks would have to be expended." Further, the omission from item 32 of the essential information relative to this tax claim is abetted by the fact that $215,000 is to be set up as a contingent fund to be used for unpredictable or unforeseen contingencies. This description for the use of funds, a substantial portion of which will have to be devoted to adjustments of the prior tax claim is itself a material misrepresentation. The settlement of

this claim cannot be said to be either "unpredictable" or/and "unforeseen contingencies."

I think a good many of us have discovered similar situations where we have undeterminable tax claims pending and, rather than show such as contingent liabilities or provide the reserves therefore, we have been very willing to say, "Oh well, they have enough in the contingency reserve to take care of it." This decision by the SEC would indicate that those of us who have done that might have been just a little bit out of order.

The last case mentioned is the Missouri Pacific case, with which you are all undoubtedly familiar, and that is known as "Release No. 2325 of the Securities and Exchange Commission." It is rather exhaustive and consists of 17 pages. Some of it applies to the legal, including the reorganization under 77-B; the part we are interested in is the liability, or the contingent liability, in the matter of four of certain contracts. I won't take the time to go into the full details, but will summarize in a brief way the "meat" of that contingency.

The Missouri Pacific Railroad agreed to buy certain stocks from the Terminal Shares, Inc., a wholly owned subsidiary of the Missouri Pacific Railroad, provided the Interstate Commerce Commission permitted it. In the event that the Interstate Commerce Commission did not give its consent (and, incidentally, it might be mentioned that the Missouri Pacific was owned by the Alleghany Corporation and according to information contained herein was apparently in a position to suggest the consent or be against the consent as far as the Interstate Commerce Commission was concerned) there was to be deposited with a trust company certain funds for the purchase of those securities, and if the purchase could not go through legally—that is, with the consent of the Interstate Commerce Commission—the securities could be sold at auction by the subsidiary—the Terminal Shares, Inc.—and the Missouri Pacific Railroad was to make up any deficiency as between the agreed contract price plus interest, or would receive the benefit of any excess.

You can readily see that here is a possible question of a real liability as well as a contingent liability. For the sake of the argument, however, the Securities and Exchange Commission accepted that it was a contingent liability. "The contracts provide that your company agrees to buy the stock as and if it shall be authorized by this Commission to acquire control of the properties of the several companies." (the "Commission" in that case is the Interstate Commerce Commission) "As the Commission has not authorized the acquisition or control, and as your company's annual report for the year ending December 31, 1939 indicates no payments were made in that year, the amount in question should be included in Account #727" (that is the account known in railroad or public utility accounting as "Other Unadjusted Debits") "until such time as is decided what disposition is to be made of the amount."

I could continue but, as I said before, it might take considerable of your time which I believe you are more anxious to utilize for your own particular problems; but I do believe it would be very worthwhile to read the discussion in this release. I repeat the number—it is Release No. 2325, under the Securities and Exchange Act of 1934, issued December 6, 1939.

In searching for other writings, and I found that Mr. B. Bernard Greidinger has written a volume called "Accounting Requirements of the SEC", published within the last

two or three years by Ronald Press. His discussion on Contingent Liabilities covers about three pages, but in effect does go beyond anything you or I or the most of us know at this time about contingent liabilities. I respectfully refer that to your consideration. Incidentally, he mentions generally the requirements as quoted in Regulation S-X, but then he does give a few cases that are directly related to our subject.

Finally, I refer you to the publication known as the "United States of America before the Securities and Exchange Commission in the matter of McKesson & Robbins"—the testimony of expert witnesses, which may be obtained from the Government Printing Office for the price of 65¢. In that hearing, twelve certified public accountants were called before the Commission to give their views with respect to the procedures which the modern accounting firm and its staff now utilizes not only in verifying the usual assets and liabilities but also in determining, digging out and locating contingent liabilities. Certainly, from my knowledge of the men in our profession today, these giving testimony represent an unusually broad perspective of the different opinions which might be brought forth, and practically every one of answers given to SEC questions are similar to what Mr. Krejcu noted in his paper—"look at the minutes, the legal bills, unusual contracts, etc." That volume is not only interesting from a contingent liability viewpoint, but I think most of us will find it very enlightening for other problems in our work.

Contingent Liabilities and Commitments

By J. E. Krejcu, C.P.A.

Not so many years ago the balance sheet footnotes relating to contingent liabilities were usually limited to references to contingencies under letters of credit, for notes receivable discounted and tax litigation. Since that time there has been a gradual emphasis on the disclosure of various contingent liabilities and commitments. The contingencies currently being disclosed probably reflect the rapidly shifting economic conditions, both domestic and foreign, dynamic tax policies, both state and Federal, and the requirements under the Securities Act of 1933.

Two years ago this Committee reported that the data pertaining to the subject under discussion this evening was rather limited.* However, at that time and for the purpose of that meeting, considerable research was made of the treatment and disclosure of various contingent liabilities and commitments as noted in the published balance sheets of nationally known companies as well as of moderate-sized organizations. It may be of interest to summarize very briefly some of the items discussed at that session.

Commitments

1. Purchase commitments and unfilled sales orders.
2. Options to purchase stock.
3. Contracts for the purchase, extension or construction of

* At a Special Technical Meeting on Contingent Liabilities and Commitments held on October 26, 1938 at the Town Hall Club, New York; proceedings published in the March 1939 issue of The New York Certified Public Accountant—(Vol. IX, No. 6, page 257).

land, buildings, machinery, equipment, fixtures, etc.

4. Contracts for the purchase of stock in other corporations.
5. Contracts for conversion of bonds and stocks.

Contingent Liabilities

1. For insurance carried with mutual and reciprocal companies.
2. For pending litigation such as taxation, patent infringements, royalties under dispute, etc.
3. For the restoration of rented property at the expiration of a lease to the same state as at the time the lease was initiated.
4. For guaranty of principal and interest of subsidiary companies' bonds.
5. For guaranty of accounts receivable or installments receivable sold to financial institutions in repurchase agreements.
6. For guaranty of employees' or officers' loans.
7. For guaranty of the payment of operating expenses of subsidiary companies (eliminated in the consolidated balance sheet).
8. Financial plans whereby a convertible provision exists pertaining to converting stocks and bonds.

The foregoing are by no means an exhaustive list of the contingent liabilities that have been and are being disclosed in current balance sheets, but they may afford a basis for discussion or future reference.

Reference to some financial reports more recent than those discussed in 1938 may also be of interest. A rather striking example of a contingent liability appeared in the published balance sheet of an American Company dated December 31, 1938 (note the date), and the appended short form report dated early in 1939. In the certificate or short form report the accountants stated that they were "unable to express an opinion as to the ultimate outcome of the negotiations for the acquisition of an interest in the capital stocks of certain foreign companies, in respect of which payments an advance of X dollars has been made." As to the commitment, the balance sheet footnote stated that the company was also obligated to make further payments of X dollars pending approval of competent government authorities. (The minority interest as shown in the consolidated balance sheet was that of a French company.) It is interesting to note that the short form report was dated six months before the outbreak of the second European war. You will recall that early in 1939 the city of Jersey City proposed to assess personal property (tangible and intangible) of nationally known and other corporations who have a place of business in that city. The proposed assessments as published in New York newspapers from day to day were astronomical in amount, but fortunately by no means represented the final settlement effected by the corporations. Nevertheless, the contingent liability as it existed at that time called for disclosure, and appeared together with legal opinion in many published balance sheets published.

During the depression years many retail chain organizations obtained rent reductions on certain leases. The agreements effecting such rent reductions provided that in the event of the default of certain other happenings such reductions shall be restored in their entirety and become liabilities. The reduction for which the company is contingently liable may be considerable, particularly when calculated cumulatively.

To bring the discussion up to the minute, it may be said that the program for National Defense undoubt-

edly will give rise to the guaranty by companies of the performance of certain contracts for construction of plants and equipment by affiliated companies; to heavy commitments for the purchase of materials and to the giving effect to the usual "war clauses" by manufacturing companies; of the warranty of contracts upon sale. As in the past, the actual liability, if any, may be indeterminate, but it will be encumbent on management to make proper disclosures, and accountants should insist on such statements.

To conclude, the sources for obtaining information pertaining to contingent liabilities are fairly well established, viz., leases, minutes of meetings, invoices for legal services and various legal instruments. As such information is followed up in accordance with standard auditing procedure and contingent liabilities are ascertained, reserves may be provided in an amount that the management believes is adequate to cover any losses that may arise. If, on the other hand, the amount is indeterminate, the accountant may consider their material effect on the results of operations (such as a substantial decline in market prices of commodities), or an adverse effect on the current ratio (such as contracts for the erection of additional plant facilities), or seriously freezing of working capital (such as a disproportionately large commitment). With the view to their inclusion in the financial statements the accountant should weigh the facts, and in solving the problem of disclosure bear in mind that the financial statements may be made available to stockholders, credit grantors, the Securities and Exchange Commission and management. The concensus among accountants is that the problem of ascertainment and treatment of contingent liabilities is one of the most difficult that we have to solve but, from a study of current reports, the problem is being met.

SECURITIES AND EXCHANGE COMMISSION

Accounting Series Release No. 24
May 23, 1941

The Securities and Exchange Commission today announced the adoption of amendments to Article 1 of Regulation S-X making that Regulation applicable to the form and content of financial statements filed by investment companies in registration statements and annual reports under the Investment Company Act of 1940. Various amendments of Article 6 and the related rules of Article 12, which deal specifically with the form and content of balance sheets, income statements, and schedules for investment companies, also were adopted.

The amendments are designed to adapt the present requirements for use by companies subject to the Investment Company Act of 1940, but also are applicable to statements of investment companies filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. It is contemplated, however, that further amendments or a general revision of the requirements as to the form and content of financial statements of investment companies may result from study of the financial statements filed as part of the registration statements of investment companies under the Investment Company Act of 1940.

The text of the Commission's action follows:

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19 (a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15 (d) and 23 (a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30 and 38 thereof, and deeming such action necessary and appropriate in the public interest and for the protection of investors and necessary for the execution of the functions vested in it by the said Acts, hereby amends Regulation S-X as follows:

Amendment No. 4 to Regulation S-X

I. Rule 1-01 is amended by adding thereto the following additional paragraph:

"(e) Registration statements and annual reports under the Investment Company Act of 1940."

II. Rule 1-02 is amended by deleting the present definition of an "Investment Company" and inserting the following in lieu thereof:

"Investment Company.—The term "investment company" means an investment company as defined in the Investment Company Act of 1940."

III. Rule 6-02 is amended by deleting captions 7, 8, 9 and 10, and by inserting the following captions in lieu thereof:

"7. *Investment in securities.*—Investments included under captions 7 to 10 shall be shown in the balance sheet either at value, showing cost parenthetically, or at cost, showing value parenthetically. For the purpose of this Rule 6-02 'value' has the meaning defined in Section 2 (a) (39) (B) of the Investment Company Act of 1940. Reserves for unrealized depreciation of securities, even if carried on the books, need not be shown if securities are shown in balance sheet at value; if securities are shown in the balance sheet at cost, such reserves if carried on the books shall be shown as deductions under appropriate captions. For securities which have been written down below cost in connection with a quasi-reorganization, such written-down amount may be stated in lieu of cost, provided the date of and a brief statement as to such write-down are shown in a footnote. State in the balance sheet for each caption the basis of determining the amount at which investments are carried.

(a) *Marketable securities.*—Show separately securities of other investment persons, exclusive of those to be included under caption 9 below.

(b) *Other securities.*—Include all securities not included under subcaption 7 (a) above, or caption 9 or 15 below.

(c) *Reserves for unrealized depreciation in value of securities.*

8. *Investments—Other than securities.*—State separately each major class. See instructions to caption 7.

9. *Investments in securities of affiliates.*—State separately in the registrant's balance sheet the amounts which in the related consolidated balance sheet are (a) eliminated and (b) not eliminated. See instructions to caption 7.

10. *Indebtedness of affiliates.* — State separately in the registrant's balance sheet that indebtedness which in the related consolidated balance sheet is (a) eliminated and (b) not eliminated. See instructions to caption 7."

IV. Rule 6-02 is further amended by deleting the second sentence of caption 22, and by inserting the following sentence in lieu thereof:

"If assets are carried in excess of cost, the amount of such excess shall be shown as reserve for unrealized appreciation arising from revaluation of assets

either here or as a separate item under caption 24—Surplus."

As amended caption 22 of Rule 6-02 reads as follows:

"*Reserves, not shown elsewhere.*—State separately in the balance sheet the total of each major class. If assets are carried in excess of cost, the amount of such excess shall be shown as reserve for unrealized appreciation arising from revaluation of assets either here or as a separate item under caption 24—Surplus."

V. Rule 6-02 is further amended by adding the following preface to the second sentence of caption 24 (c) thereof:

"In the case of closed-end companies, as defined in the Investment Company Act of 1940, indicate clearly . . ."

As amended caption 24 (c) of Rule 6-02 reads as follows:

"(c) An analysis of each surplus account setting forth the information prescribed in rule 11-02 shall be given for each period for which a profit and loss statement is filed in the form of a separate statement of surplus, and shall be referred to in the balance sheet. In the case of closed-end companies, as defined in the Investment Company Act of 1940, indicate clearly in this analysis gains or losses from transactions in securities of the person for which the statement is filed and show in a note (1) the number of shares and principal amount of bonds purchased during the period and the cost thereof, and (2) the number of reacquired shares and principal amount of bonds sold during the period, the cost, the amount received from sale, and the gain or loss realized."

VI. Rule 6-04 is amended by adding the following sentence to Schedule XIV:

"This schedule need not be filed, however, if all the information called for by Rule 12-17 is included in the profit and loss or income statement."

As amended the instructions for Schedule XIV of Rule 6-04 read as follows:

"The schedule prescribed by rule 12-17 shall be filed as to all income received from dividends included in each profit and loss statement filed. This schedule need not be filed, however, if all the information called for by rule 12-17 is included in the profit and loss or income statement."

VII. Rule 12-19 is amended in the following manner:

(a) By deleting the first three sentences of Note 2 (a), and by inserting the following in lieu thereof:

"Indicate by an appropriate symbol those securities which are non-income-producing securities. Evidences of indebtedness and preferred shares may be deemed to be income-producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no dividend declared, the issue shall not be deemed to be income-producing."

(b) By deleting Note 2 (b), and by inserting the following in lieu thereof:

"Each issue shall be listed separately: *Provided, however,* That an amount not exceeding five percent of the total of column H may be listed in one amount as 'Miscellaneous securities,' provided the securities so listed have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the statement is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public."

(c) By adding the following sentences to Note 4 thereof:

"For securities which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given. State in a footnote to this column the aggregate cost for purposes of the Federal income tax."

(d) By adding the following sentence to Note 5 thereof:

"If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

As amended the Notes to Rule 12-19 read as follows:

"1 The required information is to be given as to all securities which were held at any time within the period. As to any class of such securities, none of which were held at the end of the most recent period, the classification required by note 2 need not be made.

2 (a) Indicate by an appropriate symbol those securities which are non-income-producing securities. Evidences of indebtedness and preferred shares may be deemed to be income-producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last "interest or dividend date, no interest was paid or no dividends declared, the issue shall not be deemed to be income-producing. Common shares shall not be deemed to be income-producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares. List separately (A) bonds; (B) preferred shares; (C) common shares. Within each of these subdivisions classify according to type of business, insofar as practicable, e.g., investment companies, railroads, utilities, banks, insurance companies, or industrials. Give totals for each group, subdivision, and class.

(b) Each issue shall be listed separately: *Provided, however,* That an amount not exceeding five percent of the total of column H may be listed in one amount as 'Miscellaneous securities,' provided the securities so listed have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the statement is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public.

3 Indicate any securities subject to option at the end of the most recent period and state in a note the amount subject to option, the option prices, and the dates within which such options may be exercised.

"4 Columns F, G and H shall be totaled. The total of column G at the close of the most recent period shall agree with the related balance sheet caption. For securities which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given. State in a footnote to this column the aggregate cost for purposes of the Federal income tax.

5 If the amount shown in column G differs from the amount shown in either column F or H, state the basis of determining the amount in column G. If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice.

6 If market value is determined on any other basis than closing prices reported on any national securities exchange, explain such other basis in a note."

VIII. Rule 12-20 is amended in the following manner:

(a) By deleting the first three sentences of Note 2 (a), and by inserting the following sentences in lieu thereof:

"Indicate by an appropriate symbol those securities which are non-income-producing securities. Evidences of indebtedness and preferred shares may be deemed to be income-producing if, on the respective last interest payment date or date for the "declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no dividend declared, the issue shall not be deemed to be income-producing."

(b) By adding the following sentences to Note 4 thereof:

"For securities which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given. State in a footnote to this column the aggregate cost for purposes of the Federal income tax."

(c) By adding the following sentence to Note 5 thereof:

"If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

As amended the Notes to Rule 12-20 read as follows:

"1 The required information is to be given as to all securities which were held at any time within the period. As

to any class of such securities, none of which were held at the end of the most recent period, the classification required by note 2 need not be made.

2 (a) Indicate by an appropriate symbol those securities which are non-income-producing securities. Evidences of indebtedness and preferred shares may be deemed to be income-producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no dividend declared, the issues shall not be deemed to be income-producing. Common shares shall not be deemed to be income-producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

"(b) Each issue shall be separately listed.

"3 Indicate any securities subject to option at the end of the most recent period and state in a note the amount subject to option, the option prices, and the dates within which such options may be exercised.

4 Columns F, G, and H shall be totaled. The total of column G at the close of the most recent period shall agree with the related balance sheet caption. For securities which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given. State in a footnote to this column the aggregate cost for purposes of the Federal income tax.

5 If the amount shown in column G differs from the amount shown in column F, state the basis of determining the amount in column G. If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice.

6 Determine, as of the balance sheet date, by an appropriate method, the estimated value of each item listed. If the amount in column H differs from the amount in column F or G, state the basis of determining the amount in column H."

IX. Rule 12-21 is amended in the following manner:

(a) By adding the following sentence to Note 5 thereof:

"For investments which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given."

(b) By adding the following sentence to Note 6 thereof:

"If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

As amended Notes 5 and 6 of Rule 12-21 read as follows:

"5 All money columns shall be totaled. The total of column G at the close of the most recent period shall agree with the related balance sheet caption. For investments which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given.

6 If the amount shown in column G differs from the amount shown in column F, state the basis of determining the amount in column G. If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

X. Rule 12-22 is amended in the following manner:

(a) By adding the following sentence to Note 5 thereof:

"For investments which have been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given."

(b) By adding the following sentence to Note 6 thereof:

"If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

As amended Notes 5 and 6 of Rule 12-22 read as follows:

"5 Columns F, G, and H shall be totaled. The total of column G at the close of the most recent period shall agree with the related balance sheet caption. For investments which have

been written down in connection with a quasi-reorganization, such written-down amounts may be stated in column F in lieu of costs, provided an appropriate explanation is given.

6 If the amount shown in column G differs from the amount in column F, state that basis of determining the amount in column G. If the amounts to be shown in column G are identical with the amounts to be shown in column F or H, a statement to that effect will suffice."

The foregoing action shall be effective June 15, 1941.

SECURITIES AND EXCHANGE COMMISSION

Accounting Series Release No. 25
May 29, 1941

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series discussing certain implications of the term "quasi-reorganization" as used to describe the corporate procedure in the course of which a deficit resulting from operations or the recognition of losses is charged to capital surplus previously existing or arising in the course of the quasi-reorganization. The opinion, prepared by William W. Werntz, follows:

"Inquiry has been made from time to time as to the conditions under which a quasi-reorganization may be said to have been effected. The term quasi-reorganization has come to be applied in accounting to the corporate procedure in the course of which a company, without the creation of a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization. Certain aspects of the problem have previously been discussed in published opinions of the Commission[1] and in three published opinions of the Chief Accountant[2]. In the amendments to Rules 6-02, 12-19, 12-20, 12-21, and 12-22 of Regulation S-X which were recently adopted in conjunction with the promulgation of a form for registration of investment companies under the Investment Company Act of 1940, the term is used in definition of circumstances under which there may be shown in lieu of the cost of securities the written-down amounts resulting from quasi-reorganization.

"It has been the Commission's view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

"(1) Earned surplus as of the date selected is exhausted;

"(2) Upon consummation of the quasi-reorganization no deficit exists in any surplus account;

"(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;

"(4) The procedure accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

"It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorgani-

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[1] See particularly In the Matter of Associated Gas and Electric Corporation, 6 SEC 605 (1940).

[2] Accounting Series Releases Nos. 1, discussing the propriety of charging losses to capital surplus rather than earned surplus; 15, discussing the nature of the disclosure to be made in subsequent statements; and 16, discussing the disclosure necessary where consent of stockholders was not obtained, such action being permissible under the applicable state law.

zation is the elimination of a deficit in earned surplus resulting from operating losses.

"In the case of the quasi-reorganization of a parent company it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Hence, dividends subsequently received from subsidiaries should be treated as income only to the extent that they are declared by subsidiaries out of earnings subsequent to the effective date. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet."

INVESTMENT COMPANY ACT

On May 23, 1941, the Securities and Exchange Commission announced the adoption of the first detailed registration form under the Investment Company Act of 1940, as well as the issuance of certain related rules. This information is contained in Release No. 133 (corrected), Investment Company Act, from which the following is taken:

The (new registration) form is specifically designed to cover management investment companies, both of the closed-end and open-end type. Forms to cover the other types of investment companies, such as fixed trusts, companies selling periodic payment plan certificates, and companies selling face amount certificates, will be promulgated in the near future.

Prior to adoption, drafts of the form were circulated to all management investment companies and the national Committee on Investment Companies, which represents a majority of the management investment companies, for their comment and criticism.

The registration form will not only be available for registration of management investment companies under the Investment Company Act of 1940, but it is contemplated that it may be used, with certain additional information, for the registration of new issues of management investment companies' securities under the Securities Act of 1933 and for registration under the Securities Exchange Act of 1934.

The form requires comprehensive information with respect to the organization, operation and management of the companies. An important feature of the form is the extent to which it requires specific and detailed statements of the companies' investment and operating policies. Under the Investment Company Act any change in the policies recited in a company's registration statement may be made only after stockholders' approval has been obtained.

The form also requires the submission of detailed financial information. In addition, it requires the submission, in condensed form, of certain significant financial data, including a statement of the asset coverage and asset values of the company's securities for the past five years, and information as to the ratio of expenses to income and assets.

The form, which is known as Form N-8B-1, was sent to approximately 300 management investment companies. Additional copies may be obtained from the Regional Offices of the Commission.

The rules relating to the form are Rule N-8B-2, adopting the form; Rule N-8C-1, relating to the filing under the Investment Company Act of copies of material already filed under other statutes administered by the Commission; and Rule N-45A-1, providing for confidential treatment of one exhibit. A technical amendment to Rules X-13A-7 and X-15D-4 under the Securities Exchange Act of 1934 was also promulgated.

Authors of Articles In This Issue

Edward F. Jannott, C.P.A.,
Member of Society.

I. Arnold Ross, C.P.A.,
Attorney and member of Society; member of Committee on State Legislation of The New York County Lawyers Association.

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